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# An Equity-Based, Multilateral Approach for Sourcing Income Among Nations

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# FLORIDA TAX REVIEW

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AN EQUITY-BASED, MULTILATERAL APPROACH  
FOR SOURCING INCOME AMONG NATIONS

*Fred B. Brown*



UNIVERSITY OF  
FLORIDA  
COLLEGE OF LAW

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# FLORIDA TAX REVIEW

Volume 11

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## AN EQUITY-BASED, MULTILATERAL APPROACH FOR SOURCING INCOME AMONG NATIONS

by

*Fred B. Brown\**

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## I. INTRODUCTION

The source of income rules used in the United States and elsewhere in large part establish the contours of income tax jurisdiction that is exercised by countries.<sup>1</sup> Source rules do this by allocating a taxpayer's income for purposes of assigning countries their rights to tax such income.<sup>2</sup> Thus, source rules are of critical importance in the functioning of the income tax rules that apply to cross-border business and investment activities.

The source rules play a vital role in the foreign tax credit system applicable to U.S. persons with foreign investment or business activities. This is because a U.S. taxpayer is subject to an annual foreign tax credit limitation, which is generally equal to the taxpayer's average U.S. tax rate multiplied by the taxpayer's foreign source income as determined under the source rules.<sup>3</sup> The source rules also play a central role in the United States' exercise of taxation over foreign persons with U.S. businesses or investments. For the most part, only U.S. source income is subject to tax under the U.S. tax regimes that apply to foreign persons.<sup>4</sup> Moreover, if the United States were to move to a full or partial territorial system for taxing U.S. persons, the source rules would assume even greater importance given that they would determine whether the United States would impose any tax (as opposed to a residual tax) on the income of U.S. persons from cross-border activities.<sup>5</sup> Other countries likewise use source rules or their

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1. See Hugh J. Ault & David F. Bradford, *Taxing International Income: An Analysis of the U.S. System and Its Economic Premises*, in NATIONAL BUREAU OF ECONOMIC RESEARCH, *TAXATION IN THE GLOBAL ECONOMY* 11, 13 (Assaf Razin & Joel Slemrod, eds., 1990) ("The source rules are central to the taxing jurisdiction asserted over both U.S. and foreign persons."); Stephen E. Shay, J. Clifton Fleming, Jr. & Robert J. Peroni, "What's Source Got to Do With It?" *Source Rules and U.S. International Tax*, 56 *TAX L. REV.* 81, 83 (2002) [hereinafter, Shay, Fleming & Peroni, *Source Rules*] (noting that "the concept of 'source' is at the heart of international taxation").

2. Compare this to the use of the arm's length method for allocating income among commonly controlled entities. See, e.g., I.R.C. § 482. Thus, whereas the arm's length method is used to allocate income among taxpayers, the source rules are used to allocate income within a particular taxpayer.

3. See I.R.C. § 904(a), (d).

4. See I.R.C. §§ 871(a), (b), 881(a), 882(a), 864(c).

5. See J. Clifton Fleming, Jr. & Robert J. Peroni, *Exploring the Contours of a Proposed U.S. Exemption (Territorial Tax System)*, 41 *TAX NOTES INT'L* 217, 226-227 (2006); cf. HUGH J. AULT & BRIAN J. ARNOLD, *COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS* 447-48 (2010) (pointing out that in countries using territorial systems, great pressure is placed on source rules because treating income as foreign source may result in the income not being taxed anywhere if countries use different source rules).

equivalent in applying foreign tax credit or territorial systems to their residents and exercising source taxation over nonresidents.<sup>6</sup>

The current approach for sourcing income suffers from two related problems. First, the source rules lack coherence in that they fail to advance a consistent normative tax policy.<sup>7</sup> While the U.S. rules are generally based on the notion of sourcing income according to the location of economic activities that generate the income, they also promote other policy concerns, such as taxing income that is not likely to be taxed by foreign countries and encouraging U.S. export activities.<sup>8</sup> More fundamentally, the source rules used by the United States and other countries fail to reflect the consistent application of the key principle appropriate for allocating nations' primary taxing rights — namely, the benefits principle, under which income should be sourced to the country that provides the taxpayer with significant governmental benefits related to the derivation of the income.<sup>9</sup> The connection to governmental benefits should be the guidepost for designing source of income rules, because the source rules define the scope of source taxation and source taxation is justified by governmental benefits provided to a nonresident by the host country.<sup>10</sup> Furthermore, even where the source rules attempt to implement an economic approach for sourcing income — an approach that can be consistent with the benefits principle — the rules in the United States and elsewhere often produce distorted binary results: that is, generally all of the income from a transaction is either domestic or foreign source even though the relevant economic factors suggest that a division of the income is warranted.<sup>11</sup> The results produced by these “single” source rules at times are arbitrary.<sup>12</sup>

The second problem is the variation in the source rules used worldwide.<sup>13</sup> This may produce double taxation — two or more countries taxing the same income, a result that would impede the free flow of business and investment capital. Or alternatively, differences in countries' sourcing approaches can lead to non-taxation — no country taxing the particular income, which may encourage tax motivated transactions.

This Article addresses both of these problems by offering an approach for sourcing income that has the potential for being adopted by countries on a multilateral basis. The Article develops an equity-based standard for sourcing that would allow for the derivation of source rules for various types of income. The core idea underlying the proposed sourcing

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6. See Ault & Arnold, *supra* note 5, at 454–57, 498–502, 506–15.

7. See *infra* notes 84–106 and accompanying text.

8. See *infra* notes 60–61, 68 and accompanying text.

9. See *infra* notes 144–48 and accompanying text.

10. See *infra* notes 144–48 and accompanying text.

11. See *infra* notes 53–59, 94–96 and accompanying text.

12. See *infra* notes 97–100 and accompanying text.

13. See *infra* Part II.C.2.

standard is the benefits principle, which calls for the sourcing of income on the basis of related government benefits. To an extent, the proposed approach is somewhat consistent with source rules currently used in the United States and elsewhere. However, unlike the U.S. rules and those of some other countries, the proposed approach would not take into account other policy concerns, with the exception of administrability. Moreover, the suggested approach would divide the income between geographical sources where more than one country provides significant governmental benefits that contribute to the earning or enjoyment of the income, whereas the current rules typically assign income to a single geographical source. By basing the source rules on a benefits principle-based standard that allows source to be divided when appropriate, this Article seeks to rationalize and harmonize the provisions used to source income for purposes of taxing cross-border investment and business activities.

This Article differs from prior work in this area in two important respects. First, it offers a multilateral approach for sourcing income, whereas earlier studies of significance have taken a national approach, evaluating for reform the source rules of the United States.<sup>14</sup> Second, unlike other scholarship devoted to the source rules, the Article develops a single standard for sourcing income that promotes equity by dividing the income tax jurisdiction of countries based on the provision of government benefits that relate to the income. Thus, the Article is important in that it develops an equity-based standard for sourcing income that may gain international acceptance.<sup>15</sup>

Part II of the Article briefly describes source rules used in the United States and other countries, reviews the principles underlying the current source rules, and describes the significant problems caused by the current approach. Part III develops a standard for devising source rules, first by identifying the benefits principle and administrability as the appropriate principles for developing the standard for sourcing income. This part then formulates a standard that would devise source rules by evaluating the source of income on the basis of three factors: the destination of the services, property, or capital giving rise to income; the location(s) of the activities giving rise to income; and the residence of the person receiving income.

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14. See AM. LAW INST., FEDERAL INCOME TAX PROJECT: International Aspects of United States Income Taxation: Proposals of the American Law Institute on United States Taxation of Foreign Persons and of the Foreign Income of United States Persons (1987) (ALI PROJECT I); Shay, Fleming & Peroni, *Source Rules*, *supra* note 1.

15. This would be analogous to the international acceptance of the arm's length principles to allocate income among commonly controlled entities. See, e.g., OECD Model Tax Convention on Income and on Capital art. 9 (2010) [hereinafter OECD Model] (calling for the use of arm's length principles to allocate income among associated enterprises).

Based on this evaluation, the rule for a given type of income may divide the source of the income among multiple locations. Part IV then illustrates the use of this standard by suggesting revised source rules for several types of income.<sup>16</sup> Part V concludes the Article.

## II. CURRENT SOURCE RULES: DESCRIPTION, PRINCIPLES, AND PROBLEMS

This Part proceeds by briefly describing source rules used in the United States and other countries. This is followed by a review of the principles underlying the current source rules, and then a description of the significant problems caused by the current approach.

### A. Description of Current Source Rules

The current approach used in the United States and other countries for sourcing income is to provide separate source rules for particular types of income. Thus, there are different rules for several categories of income, such as interest, dividends, service income, rents, royalties, and various types of property gains. In addition, while technically not source rules, statutes and treaties have provisions that limit or eliminate countries' exercise of source taxation. What follows is a brief description of these rules.

#### 1. Interest and Dividends

Interest income is typically sourced based on the residence or place of incorporation of the borrower.<sup>17</sup> This rule is usually overlaid with exceptions for business-related interest, under which interest that is associated with a business that is conducted outside the borrower's country of residence or incorporation is sourced according to the actual or presumed

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16. This Article will not address the related subject of sourcing deductions, that is, linking expense deductions to income from different sources. For purposes of both source and residence taxation, it is often necessary to determine the net income from different sources. *See, e.g.*, I.R.C. §§ 871(b), 882 (a), 904(a). This requires that deductions be allocated and apportioned to income from different sources. Under the U.S. rules, deductions are generally matched to gross income based on the factual relationship between the deductions and income. *See* Regs. §§ 1.861-8, 8T. There are also special allocation and apportionment rules for interest expense and research and development costs. *See* Regs. §§ 1.861-9, 9T, 10T, 17. While determining appropriate rules for sourcing deductions is certainly important in crafting harmonized source rules, this issue will be left for a future endeavor.

17. *See, e.g.*, I.R.C. § 861(a)(1); OECD Model, *supra* note 15, at art. 11, para. 5; *see also* Ault & Arnold, *supra* note 5, at 510 (stating that interest is generally sourced where the payer is resident).

location of that business.<sup>18</sup> Similar to interest, dividends are generally sourced according to the place of incorporation of the corporation paying the dividend,<sup>19</sup> with exceptions for situations where the corporation derives a significant portion of its income outside its country of incorporation.<sup>20</sup>

While the source rule for interest would indicate that the borrower's country of residence would generally have taxing rights over the interest payments, in most cases source taxation is prevented. Many countries have statutes that provide tax exemptions for domestic source interest received by foreign persons.<sup>21</sup> In addition, income tax treaties between countries usually give the country where the interest recipient resides the exclusive right to tax interest income.<sup>22</sup> For dividends, treaties typically reduce source taxation by limiting the source country tax rates on dividends to either fifteen or five percent.<sup>23</sup>

## 2. Rents and Royalties

Rental income from the leasing of tangible property is traditionally sourced at the location of the leased property.<sup>24</sup> Royalty income from licensing intangible property is sourced using a similar, property destination-type approach, but there are differences among countries in carrying out this approach. Under U.S. law, the source of royalty income is determined according to the place where the intangible is used.<sup>25</sup> The place of use is typically the country that is providing the legal protections that relate to the

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18. See, e.g., I.R.C. § 861(a)(1)(A), (B); OECD Model, *supra* note 15, at art. 11, para. 5. Under U.S. law prior to 2011, interest paid by a U.S. corporation or resident alien was generally treated as foreign source interest in its entirety if the payer met the 80 percent foreign business requirements contained in section 861(c) (so called 80/20 companies rule). See I.R.C. § 861(a)(1)(A) (prior to 2011). For taxable years beginning after 2010, the 80/20 source rule has been repealed, although a similar rule applies to exempt from U.S. source taxation interest (as well as dividends) paid by "existing 80/20 companies" (as defined in section 871(l)(1)). See I.R.C. § 871(i)(2)(B), (l), 881(d).

19. See, e.g., I.R.C. § 861(a)(2); OECD Model, *supra* note 15, at art. 10.

20. See, e.g., I.R.C. § 861(a)(2)(B).

21. See AM. LAW INST., FEDERAL INCOME TAX PROJECT: International Aspects of United States Income Taxation II: Proposals of the American Law Institute on United States Income Tax Treaties 194 (1992) (ALI PROJECT II); see, e.g., I.R.C. §§ 871(h), 881(c) (portfolio interest exemption); I.R.C. §§ 871(i)(2)(A), 881(d) (bank deposit interest exemption).

22. See, e.g., U.S. Model Income Tax Convention of November 15, 2006, art. 11, para. 1 [hereinafter U.S. Model].

23. See, e.g., OECD Model, *supra* note 15, at art. 10, para. 2.

24. See, e.g., I.R.C. § 861(a)(4).

25. See *id.*

intangible.<sup>26</sup> In other countries, royalties are often sourced based on the residence of the payer or the country from which payment is made.<sup>27</sup> Despite the source rules for royalties, income tax treaties typically prevent the source country from taxing royalty income that is received by residents of the other treaty country.<sup>28</sup>

### 3. Service Income

A few approaches have emerged for sourcing income from the performance of services. Some countries, including the United States, source service income according to where the services are performed.<sup>29</sup> Other countries apply a service destination approach and focus instead on the country in which the services are utilized.<sup>30</sup> Some countries use both approaches and determine a domestic source for service income if the services are either preformed or utilized in the particular country.<sup>31</sup>

### 4. Property Gains

There are several approaches for sourcing gains from the disposition of property, with the particular approach based on type of property that is involved. For sales of inventory property that is purchased by the taxpayer (as opposed to being produced by the taxpayer), the United States generally sources the income on the basis of where beneficial ownership and risk of loss pass to the buyer — the so-called title passage rule.<sup>32</sup> Other countries appear to focus on the country where the sales activities giving rise to the income takes place.<sup>33</sup> For sales of inventory property that is produced by the

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26. See Stephen E. Shay, et al., *Report of the Task Force on International Tax Reform*, 59 TAX LAW. 649, 773 (2006) [Hereinafter Shay, et al., *Task Force*].

27. ALI PROJECT II, *supra* note 21 at 199; See Ault & Arnold, *supra* note 5 at 513 (discussing the implicit source rule under the Australian non-resident withholding tax, which effectively treats royalties — as well as interest and dividends — paid by residents as Australian source income).

28. See, e.g., OECD Model, *supra* note 15, at art. 12, para. 1.

29. See, e.g., I.R.C. § 861(a)(3).

30. ALI PROJECT I, *supra* note 14, at 57; see ALI PROJECT II, *supra* note 21, at 7; Ault & Arnold, *supra* note 5, at 506.

31. See ALI PROJECT I, *supra* note 14, at 57.

32. See I.R.C. § 861(a)(6); Reg. § 1.861-7(c).

33. See Ault & Arnold, *supra* note 5, at 456 (discussing the source rule for export sales of inventory used by Japan for purposes of its foreign tax credit limitation, which treats income from such sales as foreign source only if effected through a foreign branch or in other circumstances that subject the income to a foreign tax). The United States uses this approach in treating income as U.S. source where the income is derived by nonresidents from sales of property that are attributable to a U.S. fixed place of business. See I.R.C. § 865(e)(2).

taxpayer, the United States generally sources 50 percent of the income to the country that is the situs of the production activities and 50 percent of the income to the country where title to the goods passes to the buyer.<sup>34</sup> Other countries similarly divide the source of the income between production and sales activities, but they may use different methods for determining the amount of income that is attributable to the production and sales activities.<sup>35</sup> Although technically not source rules, U.S. statutory and regulatory provisions prevent the exercise of source taxation over inventory income unless the nonresident is conducting a trade or business in the United States.<sup>36</sup> Similarly, treaties condition the exercise of source taxation over inventory income and other forms of business profits on the existence of a permanent establishment in the source country by the nonresident,<sup>37</sup> which is generally a fixed place of business through which the business is conducted.<sup>38</sup>

The United States generally sources gain on the sale of other types of property based on the residence of the seller.<sup>39</sup> Under this rule, gain from the sale of a financial asset, such as corporate stock, by a foreign person would generally be foreign source.<sup>40</sup> Most other countries also generally source investment gains based on the residence of the seller.<sup>41</sup> However, several countries, contrary to the U.S. rule, do impose a source tax on gains realized by a nonresident on the sale of stock in a resident corporation.<sup>42</sup> Under the

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34. See Reg. § 1.863-3.

35. See ALI PROJECT II, *supra* note 21, at 8. In addition, other countries would probably focus on the location of the sales activities as opposed to where title passes in sourcing the sales portion of such income.

36. See I.R.C. §§ 871(a), (b), 881(a), 882(a), 864(b); Reg. § 1.1441-2(b) (excluding most gains from the definition of FDAP income, which is the base of the U.S. gross basis source tax regime).

37. See, e.g., OECD Model, *supra* note 15, at art. 7.

38. See, e.g., OECD Model, *supra* note 15, at art. 5.

39. See I.R.C. § 865(a).

40. See I.R.C. §§ 865(a), 865(g). There are other limitations on the source taxation of gains from sales of stocks or securities. Under U.S. law, the trading of stocks or securities is generally not considered to be a U.S. trade or business for purposes of U.S. net basis source taxation, and stock or security gains are generally not subject to U.S. gross basis source taxation. See I.R.C. §§ 864(b)(2), 871(a), (b), 881(a), 882(a); Reg. § 1.1441-2(b). In addition, treaties generally prevent the source taxation of stock or security gains. See, e.g., U.S. Model, *supra* note 22, at art. 13, para. 6.

41. See ALI PROJECT II, *supra* note 21, at 202.

42. See *id.*; Joseph L. Andrus, *Determining the Source of Income in a Changing World*, 75 TAXES 839, 844 (1997); Ault & Arnold, *supra* note 5, at 497–98, 509; Kimberly S. Blanchard, *Cross-Border Tax Problems of Investment Funds*, 60 TAX LAW. 583, 585 (2007) (stating that many countries tax nonresidents on stock

U.S. rule, gain on the sale of an intangible would generally be sourced according to the residence of seller.<sup>43</sup> An exception exists for contingent payment sales, in which case the gain is sourced under the royalty rule discussed above.<sup>44</sup> Gains from sales of real property are sourced in the country in which the real property is located.<sup>45</sup> In the United States, U.S. source treatment also applies to gains from indirect holdings of U.S. realty through U.S. corporations whose principal assets are U.S. real estate.<sup>46</sup>

### B. Principles Underlying the Current Source Rules

A comprehensive rationale has never been offered for the source rules that exist in the United States and other countries.<sup>47</sup> Instead, the current rules are a product of balancing a complex set of conflicting principles, considerations, and claims as they apply to particular income types.<sup>48</sup>

#### 1. Connection to Governmental Benefits/Economic Nexus

An important principle used in formulating source rules is the view that income should be sourced to the country that provides governmental services and protections that are used in deriving the income.<sup>49</sup> In practice, this policy is usually carried out by associating income with a geographic source based on an economic nexus between the income and a particular

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gains with respect to “local corporations, at least where such corporations are not publicly traded and locally listed”).

43. See I.R.C. § 865(a).

44. See I.R.C. § 865(d)(1); *supra* notes 25–26 and accompanying text.

45. ALI PROJECT I, *supra* note 14, at 37; see, e.g., I.R.C. §§ 861(a)(5), 897(c).

46. See I.R.C. §§ 861(a)(5), 897(c).

47. See ALI PROJECT I, *supra* note 14, at 18; Andrew Walker, *Exceptions in Search of a Rule: The Source and Taxability of “None of the Above” Income 4* (Columbia Law School Tax Policy Colloquium, 2009), [http://www.law.columbia.edu/null/download?&exclusive=filemgr.download&file\\_id=153762](http://www.law.columbia.edu/null/download?&exclusive=filemgr.download&file_id=153762) (stating that there is no obvious unifying principle that explains the existing U.S. source rules).

48. See ALI PROJECT I, *supra* note 14, at 18; Walker, *supra* note, 47 at 5; cf. STAFF OF THE JOINT COMM. ON TAXATION, DESCRIPTION AND ANALYSIS OF PRESENT-LAW RULES RELATING TO INTERNATIONAL TAXATION, JCX-40-99 (1999) (stating that various factors determine the source of income for U.S. purposes, including the location or nationality of the payer and recipient, and the location of the activities and assets that generate income).

49. See, e.g., ALI PROJECT I, *supra* note 14, at 18; Lawrence Lokken, *What is this Thing Called Source?* 3–5 (Miami Law Research Paper Series, 2011), <http://ssrn.com/abstract=1795265> [hereinafter Lokken, *Source*] (stating that several source rules can be explained by a principle that sources income based on the location of governmental services and protections utilized in earning income).

country.<sup>50</sup> Thus, in determining the source of income from activities, the focus is typically on the country in which income-producing activities occur.<sup>51</sup> Likewise, the source of income derived from property or capital is often determined to be the country where the property or capital is used.<sup>52</sup>

Income may well have an economic nexus to two or more countries. For example, a bank may perform lending activities in one country in connection with a loan made to a borrower who resides in another country; in this case, there would be a conflict between the activities and utilization bases for sourcing income.<sup>53</sup> Or the conflict could involve the activities basis alone, for example, where two selling branches participate in one sales transaction. In most cases, the source rules resolve such conflicts by sourcing the income to one of the countries involved.<sup>54</sup> This is often determined by deciding which country has the stronger source claim,<sup>55</sup> based either on the country with the aspects of the transaction that have the greatest economic significance<sup>56</sup> or the country that is providing the most important public benefits related to the derivation of the income.<sup>57</sup> Sometimes conflicting source claims are resolved by determining whether one of the competing countries is likely to tax the income, a principle that is discussed below.<sup>58</sup> In some cases, however, source conflicts are resolved by dividing the income between two countries; for example, this approach is used to source inventory income where the inventory is produced in one country and sold in another.<sup>59</sup>

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50. See, e.g., U. S. Treas. Dept, THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY 399 (1985) [hereinafter TREASURY II] (stating that appropriate source rules "should reflect the location of the economic activity generating the income and the source of legal protections facilitating the earning of that income"); ALI PROJECT I, *supra* note 14, at 19; cf. MICHAEL J. MCINTYRE, THE INTERNATIONAL INCOME TAX RULES OF THE UNITED STATES 3-67 to 3-68 (1996) [hereinafter McIntyre, *Tax Rules*] ("To the extent possible, income should be sourced in a country where it has some economic nexus."). As discussed below, economic nexus is an incomplete surrogate for the benefits principle. See *infra* note 152 and accompanying text.

51. See, e.g., ALI PROJECT I, *supra* note, 14 at 19.

52. See *id.*

53. See *id.*

54. See, e.g., I.R.C. §§ 861(a)(4), 865(e)(2).

55. See ALI PROJECT I, *supra* note 14, at 19.

56. See *id.* at 45.

57. See Lawrence Lokken, *The Sources of Income From International Uses and Dispositions of Intellectual Property*, 36 TAX L. REV. 233, 239-40 (1981) [hereinafter Lokken, *Intellectual Property*].

58. See *infra* Part II.B.2.

59. See *supra* notes 34-35 and accompanying text.

## 2. *Expectation that Another Country Will Be Taxing the Income*

Another principle that is sometimes used to source income is whether it is expected that other countries will be taxing the income.<sup>60</sup> The United States uses this principle in sourcing several types of income for purposes of the foreign tax credit limitation.<sup>61</sup> The concern underlying this principle is international under taxation. That is, if income is included in calculating a residence country's foreign tax credit limitation, but the income is not taxed by another country, the taxpayer would be able to cross-credit excess foreign tax credits on other foreign income against the pre-credit residence country tax on the income, thus resulting in effectively no tax or a reduced tax on the income.<sup>62</sup> Similarly, if the residence country uses a territorial system, exempting income that is not taxed by another country would mean that no country is taxing the income.

To prevent this, a residence country can use the expected-to-tax principle to treat income as domestic source, thus removing it from either the foreign tax credit limitation or foreign income exemption. When used, this principle may serve as a tiebreaker in determining source where the income has an economic connection to two or more countries, but only one of the countries is expected to tax the income.<sup>63</sup> Because of a concern that the expected-to-tax principle still allows for substantial cross-crediting opportunities, some commentators go further and call for an investigation of whether it is feasible to treat income as foreign source for foreign tax credit limitation purposes only where a foreign country imposes a significant tax on the income.<sup>64</sup> In this regard, some countries use a subject-to-tax requirement for exempting foreign income under territorial tax systems.<sup>65</sup>

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60. See STAFF OF THE JOINT COMM. ON TAXATION, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 917-18, 933 (1987) [hereinafter 1986 BLUEBOOK]; Andrus, *supra* note 42, at 843-44.

61. See 1986 BLUEBOOK, *supra* note 60, at 917-18, 932-33 (sales of personal property; income from space and certain ocean activities).

62. See *id.* at 917-18.

63. Cf. McIntyre, *Tax Rules*, *supra* note 50, at 3-68 to 3-69 ("To the extent feasible, income with an economic nexus in more than one country should be sourced in a country that is inclined to subject the income to taxation.").

64. See Shay, Fleming & Peroni, *Source Rules*, *supra* note 1, at 151-52; see also Robert J. Peroni, *A Hitchhiker's Guide to Reform of the Foreign Tax Credit Limitation*, 56 SMU L. REV. 391, 396 (2003). These commentators acknowledge the administrative difficulties of such an approach.

65. See Shay, Fleming & Peroni, *Source Rules*, *supra* note 1, at 150; see also I.R.C. § 865(e)(1) (personal property gains of U.S. residents otherwise subject to residence-based sourcing are treated as foreign source where the sale of the personal property is attributable to an office or fixed place of business maintained by the U.S. resident in a foreign country, provided that at least a ten percent income tax is actually paid to a foreign country with respect to the gain).

### 3. National Interests Unrelated to Traditional Tax Policy Goals

A country's national interests unrelated to traditional tax policy goals may also affect the design of source rules. For example, the United States uses the source rules in order to provide export incentives. In 1986 the United States generally repealed the title passage rule for sourcing personal property gains because it did not want U.S. taxpayers to be able to generate foreign source income on sales that were not likely to be subject to a foreign tax (an application of the expected-to-tax principle discussed above).<sup>66</sup> Such low or non-taxed foreign income could be used to absorb excess foreign tax credits on high-taxed foreign income.<sup>67</sup> However, the United States retained the title passage rule for sales of inventory out of a concern that the repeal of this rule for inventory sales would create difficulties for U.S. businesses competing in international commerce, especially given the substantial U.S. trade deficit at that time.<sup>68</sup> Thus, the United States' continued use of the title passage rule for inventory sales is a form of export incentive.

In addition, as mentioned above, many countries, including the United States, generally provide tax exemptions for domestic source interest income received by nonresidents.<sup>69</sup> The purpose for the portfolio interest exemption is to allow domestic borrowers unrestricted access to the Eurobond market, where debt securities are generally free of taxes withheld at source and where the issuer would generally be required to pay interest net of any source tax.<sup>70</sup> To the extent that a source withholding tax is imposed, a borrower in the Eurobond market would generally have to gross up the interest payment to cover the tax.<sup>71</sup> The exemptions for interest promote national, non-tax policy objectives by allowing less costly borrowings by domestic persons, as well by encouraging non-residents to lend money to residents of a particular country.<sup>72</sup>

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66. See 1986 BLUEBOOK, *supra* note 60, at 918.

67. See *id.*

68. See *id.*

69. See *supra* note 21 and accompanying text.

70. See STAFF OF THE JOINT COMM. ON TAXATION, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 388–89 (1984).

71. See *id.*

72. See ALI PROJECT II, *supra* note 21, at 195 (stating that the U.S. tax exemptions for interest reflect a policy judgment that it is critical to stimulate or preserve the willingness of non-residents to lend to U.S. borrowers); Yoram Keinan, *The Case for Residency-Based Taxation of Financial Transactions in Developing Countries*, 9 FLA. TAX REV. 1, 26 (“The portfolio-interest exception is perhaps the purest example of enlightened self-interest and realism in attracting foreign capital.” (quoting from Dan R. Mastromarco & Lawrence A. Hunter, *The U.S. Anti-Savings Directive*, 2002 TNT 247–28)). Similarly, the U.S. rules that generally treat the

#### 4. Principles Reflected in Treaties

As noted above, treaties typically limit a country's exercise of source taxation by reducing or eliminating the withholding tax on investment income such as interest, dividends, and royalties.<sup>73</sup> An important reason for the reduction of withholding taxes on investment income is to avoid excessive taxation by the source country.<sup>74</sup> Gross basis withholding taxes that take no account of expenses associated with the income can result in a very high rate of tax on the net income from a transaction. The quintessential example is interest income derived by a financial institutional upon relending funds that are borrowed from others; in this situation, a significant gross basis tax may be confiscatory in that it could exceed the amount of net income from the transaction.<sup>75</sup>

Another, apparent reason for treaty provisions that reduce or eliminate source taxation on investment income is the notion that the source country's claim to tax such income may be considered to be relatively weak.<sup>76</sup> The fact that the general elimination of the source tax on interest applies not only to financial institutions but also to other interest recipients suggests that another principle is at work besides preventing excessive source taxation.<sup>77</sup> Likewise, the treaty rate on dividends, typically fifteen percent, seems lower than necessary to address concerns of a high rate of source tax on net income, given the degree of associated expenses usually incurred in connection with portfolio investments.<sup>78</sup>

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trading of stocks or securities as not constituting a U.S. trade or business were enacted to encourage foreign persons to invest in U.S. capital markets. *See id.* at 54.

73. *See supra* notes 22–23, 28 and accompanying text.

74. *See* ALI PROJECT II, *supra* note 21, at 9.

75. *See id.*

76. *See id.* at 194 (referring to this as a possible basis for the general treaty elimination of source taxation of interest income); Michael J. Graetz & Itai Grinberg, *Taxing International Portfolio Income*, 56 TAX L. REV. 537, 569 (2003) (stating that the source country's claim to tax portfolio income is more attenuated than its claim to tax business income and that the claims of the residence country seem to deserve priority in the inter-nation allocation of tax jurisdiction over portfolio income; pointing out that primary allocation of taxing rights over portfolio income reflects this priority).

77. *See* ALI PROJECT II, *supra* note 21, at 193–94.

78. *Cf.* OECD Model Tax Convention on Income and on Capital art. 10 cmt. (2008) [hereinafter OECD Model 2008] (stating that the 15 percent treaty rate on dividends appears to be a reasonable maximum rate given that the source country can already tax the corporation's profits); *but see* ALI PROJECT II, *supra* note 21, at 184 (stating that the object of treaty provisions that limit the source country rate on dividends seems to be keep the rate low enough so that in many cases the source tax will not exceed the net basis tax that would be imposed in the residence country).

## 5. *Administrability*

Administrability is an important consideration in devising source rules.<sup>79</sup> Although more than one country may be connected to the derivation of income, the current source rules usually determine a single source apparently because of a concern that a multi-source approach would be overly complex.<sup>80</sup> Source rules also attempt to avoid detailed factual inquiries. In this regard, both the title passage rule<sup>81</sup> and the 50–50 source rules used by the United States in a few contexts<sup>82</sup> allow for bright line determinations of source. Simplicity is especially desirable for the source rules that are used to determine withholding obligations,<sup>83</sup> such as those for interest, dividends, and royalties.

### C. *Problems with the Current Source Rules*

The current approach for sourcing income suffers from two fundamental and related problems. First, the source rules lack coherence in that they fail to advance a consistent normative tax policy. In particular, the rules fail to reflect the consistent application of the key principle appropriate for allocating nations' primary taxing rights — namely, the benefits principle. And second, because of a lack of coherence, there may be considerable variation in the source rules used worldwide, thus increasing the likelihood of double taxation and non-taxation.

#### 1. *Lack of Coherence*

The current sources rules employed in the United States and elsewhere fail to advance a consistent normative tax policy.<sup>84</sup> This leads to

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79. See ALI PROJECT I, *supra* note 14, at 19; McIntyre, *Tax Rules*, *supra* note 50, at 3–66.

80. See ALLISON CHRISTIANS, SAMUEL A. DONALDSON & PHILIP F. POSTLEWAITE, UNITED STATES INTERNATIONAL TAXATION 20–21 (2008).

81. See *supra* note 32 and accompanying text.

82. See I.R.C. §§ 863(c), 863(e); Treas. Reg. § 1.863-3.

83. See McIntyre, *Tax Rules*, *supra* note 50, at 3–66.

84. See Shay, Fleming & Peroni, *Source Rules*, *supra* note 1, at 83–84 (“Because no clear economic or equitable principles guide the formulation of rules to divide income and expense by geographic origin, the construction of these rules has been a significantly arbitrary exercise.”) & n.3 (“[T]he claimed rationale for most source rules has a substantial element of arbitrariness.”); Ruth Mason, *Tax Expenditures and Global Labor Mobility*, 84 N.Y.U. L. REV. 1540, 1591 (2009) (stating that the source rules have long been criticized for their arbitrariness); Michael J. Graetz, *A Multilateral Solution for the Income Tax Treatment of Interest Expenses*, 62 BULL. INT’L TAX’N 486, 489 (2008) [hereinafter Graetz, *Multilateral Solution*]

different sourcing approaches for economically similar types of income.<sup>85</sup> For example, dividends are generally sourced based on the country of incorporation of the corporation paying the dividend.<sup>86</sup> In contrast, as a result of the expected-to-tax principle,<sup>87</sup> stock gains are generally sourced under the U.S. rules according to the residence of the seller.<sup>88</sup> Yet, in substance the two items are quite similar given that stock gains represent a market capitalization of future earnings.<sup>89</sup> The different source consequences on the sale versus license of a patent are also a result of basing source rules on different principles.<sup>90</sup> Similarly, the source tax exemption that generally applies to interest, which is to allow domestic borrowers unrestricted access

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(stating that it is well known that “the ‘source’ of income is not well grounded economically, nor is it conceptually straightforward,” that in many instances “archaic rules and distinctions prevail,” and that it may be that the “current sourcing rules seem arbitrary and archaic”); Edward D. Kleinbard, *The Lessons of Stateless Income* 56 (USC Legal Studies Research Paper No. 11-7, 2011), <http://ssrn.com/abstract=1791783> [hereinafter Kleinbard, *Lessons*] (“[T]he global tax norms that define the geographic source of income or expense are largely artificial constructs, difficult to administer and often devoid of any conceptual foundation.”); Ilan Benshalom, *The New Poor at Our Gates: Global Justice Implications for International Trade and Tax Law*, 85 N.Y.U. L. REV. 1, 76 (2010) (arguing that “the notorious complexity of source rules is due primarily to a lack of normative comprehension as to what they are expected to achieve”); cf. Arthur J. Cockfield, *The Rise of the OECD as Informal “World Tax Organization” Through National Responses to E-Commerce Challenges*, 8 YALE J. L. & TECH. 136, 175 (2006) (referring to observations that international tax policy suffers from a degree of arbitrariness because of a lack of agreement on guiding principles).

85. See Shay, Fleming & Peroni, *Source Rules*, *supra* note 1, at n.3 (providing an example of the often capricious nature of the source rules that involves the title passage rule for sales of inventory); cf. Willard B. Taylor & Diana L. Wollman, *Why Can’t We All Just Get Along: Finding Consistent Solutions to the Treatment of Derivatives and Other Problems*, 53 TAX LAW. 95, 95, 113–18 (1999) (pointing out the differences in the source rules applying to several types of derivative financial instruments and the lack of a seeming purpose for such; suggesting that there could be a single rule for sourcing derivative gains and losses).

86. See *supra* notes 19–20 and accompanying text.

87. See *supra* notes 60–63 and accompanying text.

88. See *supra* notes 39–40 and accompanying text. It should be noted that the expected-to-tax principle is problematic in some cases, in that a determination that other countries are not imposing a source tax on a particular type of income may not always be correct. See Andrus, *supra* note 42 (pointing out that the United States’ application of residence based sourcing of gains from the disposition of foreign corporate stock pursuant to the expected-to-tax principle can result in double taxation because a significant number of countries do tax nonresidents on such gains).

89. See Shay, Fleming & Peroni, *Source Rules*, *supra* note 1, at 122.

90. See *infra* notes 105–106 and accompanying text.

to the Eurobond market,<sup>91</sup> is inconsistent with the general source taxation of other types of investment income, such as dividends, rents, and royalties.<sup>92</sup>

More fundamentally, the rules fail to reflect the consistent application of the key principle appropriate for allocating nations' primary taxing rights — namely, the benefits principle. As developed more fully in the next part,<sup>93</sup> the connection to governmental benefits should be the guidepost for designing source of income rules, because the source rules define the scope of source taxation and source taxation is justified by governmental benefits provided to a nonresident by the host country. In this regard, equity supports host country taxation of nonresidents who benefit from host country governmental services so that the costs of these services are not borne solely by residents of that country.

While the economic nexus principle can function to a degree as a surrogate for focusing on governmental benefits,<sup>94</sup> the general binary nature of the source rules results in a failure to appropriately allocate primary tax jurisdiction in accordance with the provision of government benefits. As discussed above, the current source rules often assign all of the income to a single geographic source even though relevant economic activities occur in more than one country.<sup>95</sup> Although administrative considerations counsel against a sourcing approach that would take into account all countries that might have some connection to the income,<sup>96</sup> one certainly should question the soundness of the current approach that usually ignores all but one of the connected countries. Moreover, the decision to choose a particular country as the most important either in terms of economic contribution or provision of public benefits often is arbitrary.<sup>97</sup> For example, where an intangible is produced in one country and licensed for use in another country, is it so clear that the latter country is the most important in the derivation of the income?<sup>98</sup>

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91. See *supra* notes 21, 70–72 and accompanying text.

92. See *supra* notes 19–20, 24–27 and accompanying text.

93. See *infra* Part III.B.1.

94. See *infra* notes 149–52 and accompanying text.

95. See *supra* notes 53–59 and accompanying text.

96. See *supra* notes 79–83 and accompanying text.

97. See Mason, *supra* note 84, at 1591 n.195 (noting different possible bases for sourcing sales income (where title passes, place of sale, or place of consumption) and interest income (including the residence of the borrower, where the principal is either made available or used, or where interest payments are made)); cf. Michael J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 TAX L. REV. 261, 317 (2001) [hereinafter Graetz, *Inadequate Principles*] (stating that the source rules “should be overhauled to be better linked to the location of real economic activity, the location of customers, workers, or assets”).

98. Under section 861(a)(4), the royalty income will be sourced where the intangible is being used.

And when compared to a similar situation involving services performed in one country that are utilized in another country, the U.S. source rules appear inconsistent, given that the source of the service income typically will be in the country in which the services are performed.<sup>99</sup> (As mentioned above, some countries use a service destination approach for sourcing service income.<sup>100</sup>)

The arbitrary and inconsistent results of single source rules are exacerbated by the need to characterize transactions.<sup>101</sup> Characterization is particularly necessary and often problematic in the case of transactions involving intangibles and electronic commerce, where the income from a given transaction may take the form of royalties, compensation, or property gains based on the specific facts and circumstances.<sup>102</sup> And because the single source rules produce very different results depending on the type of income involved,<sup>103</sup> a great deal turns on how income is characterized.<sup>104</sup> For example, where a U.S. resident develops an invention in the United States, obtains a foreign patent on the invention, and then sells the foreign patent for a lump sum amount, all of the gain will be U.S. source;<sup>105</sup> however, if instead of selling the patent the taxpayer licenses the patent in exchange for a lump sum royalty for a period that is slightly less than the patent's remaining life, all of the income would be foreign source.<sup>106</sup> Despite the similarity in the substance of these two alternatives, the source results are quite different.

## 2. Variation in Source Rules Used Worldwide

Because of a lack of coherence, there may be considerable variation in the source rules used worldwide.<sup>107</sup> This raises the concern of double

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99. I.R.C. § 861(a)(3).

100. See *supra* notes 30–31 and accompanying text.

101. See Mason, *supra* note 84, at 1591 (referring to disputes about how to classify income).

102. See ALI PROJECT I, *supra* note 14, at 43; Andrus, *supra* note 42, at 855–56; David G. Noren, Commentary, *The U.S. National Interest in International Tax Policy*, 54 TAX L. REV. 337, 345 (2001) (pointing out that many electronic commerce activities can plausibly be analogized to any of these categories).

103. See *supra* Part II.A.

104. See Noren, *supra* note 102, at 345.

105. I.R.C. §§ 865(a), 865(g)(1). This assumes that the sale was not attributable to a foreign office maintained by the U.S. resident and subject to foreign tax of at least ten percent. See I.R.C. § 865(e)(1).

106. I.R.C. §§ 861(a)(4), 862(a)(4).

107. See ALI PROJECT I, *supra* note 14, at 14 (stating that “the rules defining the source of income may vary considerably from country to country”); Ault & Arnold, *supra* note 5, at 498–502, 506–09 (discussing differences in countries’ approaches for attributing income to domestic branches, determining the source of employment income, and exercising source taxation over gains derived by

taxation — that two or more countries are taxing the same income, a result that would impede the free flow of business and investment capital.<sup>108</sup> Or alternatively, differences in countries' sourcing approaches can lead to non-taxation — that no country is taxing the particular income, which may encourage inefficient, tax-motivated transactions.<sup>109</sup>

Where more than one country has a connection to an income item (which is often the case), the single source approach requires that the income be sourced to only one of the countries. In this regard, nations may come to a different conclusion as to the appropriate country, thus creating differences in source rules.<sup>110</sup> For example, some countries source service income based on where the services are performed, while others focus on where the services are utilized<sup>111</sup> or a mixture of the place of performance, the place of contract, and place of payment.<sup>112</sup> Likewise, countries choose the single source differently with respect to royalty income, with some countries using the location of the payer or place of payment, while other countries focus on where the intangible is being used.<sup>113</sup> In addition, countries use substantially

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nonresidents from disposing of substantial shareholdings in domestic corporations); Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for Taxing Business Profits, OECD, *Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-Commerce? Final Report* 26, <http://www.oecd.org/dataoecd/58/53/35869032.pdf> [hereinafter OECD, *E-Commerce*] (pointing out that even developed countries have different approaches for determining source taxation of business profits); Oleksandr Pastukhov, *Going Where No Taxman Has Gone Before: Preliminary Conclusions and Recommendations Drawn from a Decade of Debate on the International Taxation of E-Commerce*, 36 RUTGERS COMPUTER & TECH. L.J. 1, 6-7 (2009) (pointing out that the lack of uniformity among nations in taxing electronic commerce leads to taxing authorities being perplexed over the country that should have taxing rights).

108. See McIntyre, *Tax Rules*, *supra* note 50, at 1-3 to 1-4; Graetz, *Multilateral Solution*, *supra* note 84, at 489.

109. See McIntyre, *Tax Rules*, *supra* note 50, at 1-4; Graetz, *Multilateral Solution*, *supra* note 84, at 489.

110. See Michael J. McIntyre, *The Use of Combined Reporting by Nation-States*, in THE TAXATION OF BUSINESS PROFITS UNDER TAX TREATIES, ch. 8 (Brian J. Arnold, Jacques Sasseville & Eric M. Zolt, eds.) 263 (2003) ("Because the source of income is not obvious in many cases, the source rules adopted by various countries sometimes conflict.").

111. See *supra* notes 29-31 and accompanying text.

112. See Ault & Arnold, *supra* note 5, at 506-07 (discussing the Australian approach for sourcing employment income for purposes of exercising source taxation over nonresidents).

113. See *supra* notes 25-27 and accompanying text. While countries generally source interest income based on the residence of the borrower (see *supra* notes 17-18 and accompanying text), for purposes of its foreign tax credit limitation, Australia sources interest that is not subject to a foreign tax based on the where the

different approaches in attributing income to domestic branches of nonresidents for purposes of exercising source taxation.<sup>114</sup> In this regard, some countries focus on the economic connection between income items and the branch, while other countries use “force of attraction” approaches that attribute domestic source income to the branch regardless of an actual economic connection, with source determined based on an independent set of source rules.<sup>115</sup> The details of the approaches for sourcing branch income tend to be relatively undeveloped — for example, the source rules are sometimes from judge-made law that operate on a facts-and-circumstances or similar basis.<sup>116</sup>

Moreover, even if countries decided their single source rules in the same way, there could still be differences in source results where countries characterized income items differently.<sup>117</sup> Assume that another country has the same source rules as the United States with respect to service income and royalties, but uses different rules for characterizing transactions as either the performance of services or the licensing of an intangible. Under these circumstances, the United States and the other country would source a given cross-border transaction differently if the United States characterized the transaction as the performance of services while the other country viewed it as the licensing of an intangible.

Not surprisingly, the use of different principles for devising source rules can lead to different source rules. For example, based on the expected-to-tax principle,<sup>118</sup> the United States generally sources stock gains based on the residence of the seller.<sup>119</sup> However, several countries impose a source tax on gains realized by a nonresident on the sale of stock in a resident corporation,<sup>120</sup> presumably on the basis of the economic nexus principle.<sup>121</sup>

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funds are made available, which may be the place where the funds are advanced or where the contract was executed. *See* Ault and Arnold, *supra* note 5, at 457.

114. *See* Ault & Arnold, *supra* note 5, at 498.

115. *See id.* at 499.

116. *See id.* at 500 (discussing the Australian facts-and-circumstances approach for business income, which appears to source sales income where the contract is made; discussing the Canadian approach under which income is treated as domestic source if it may be allocated in a reasonable manner to a nonresident’s Canadian branch).

117. *See* ALI PROJECT I, *supra* note 14, at 37, n.46 (noting the problem of conflicting characterizations of transactions by countries); ALI PROJECT II, *supra* note 21, at 235 (discussing the potential for double taxation or under taxation where countries characterize transactions differently); Andrus, *supra* note 42, at 856 (same).

118. *See supra* notes 60–63 and accompanying text.

119. *See supra* notes 39–40 and accompanying text.

120. *See supra* note 42 and accompanying text.

121. *See supra* notes 49–52 and accompanying text.

This difference in treatment can lead to double taxation where a U.S. resident sells stock in a foreign corporation that results in a source tax in the corporation's home country.<sup>122</sup>

In situations where countries use different domestic source rules, bilateral income tax treaties may resolve conflicts in source rules. U.S. treaties typically provide that for the purposes of the U.S. foreign tax credit limitation, income that may be taxed by the other country under the treaty will be sourced in that country.<sup>123</sup> Sometimes treaties even provide explicit source rules in separate articles.<sup>124</sup> Thus, for example, treaties may prevent double taxation in the situation where a U.S. resident is subject to a source tax on the sale of foreign corporate stock.<sup>125</sup> However, existing treaties fail to comprehensively deal with potential conflicts in domestic source rules. In this regard, treaties often lack specific details with regard to attributing business profits to permanent establishments,<sup>126</sup> and countries may interpret such provisions differently.<sup>127</sup> Moreover, in limiting source taxation and guaranteeing that countries use foreign tax credit or exemption systems, treaties aim to avoid double taxation, and thus do not prevent the non-taxation of cross-border income that results when countries' varying source rules create underlapping tax jurisdiction.<sup>128</sup> Furthermore, a bilateral treaty-based solution to the problem of double taxation or non-taxation stemming from source rule conflicts is an incomplete solution, because treaties between countries may not always exist.<sup>129</sup>

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122. See Andrus, *supra* note 42, at 844.

123. See U.S. Model, *supra* note 22, at art. 23, para. 3; ALI PROJECT II, *supra* note 21 at 233–34.

124. See ALI PROJECT II, *supra* note 21, at 234.

125. See, e.g., Convention Between the U.S. and Spain for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Feb. 22, 1990, art. 13, para. 4, <http://www.irs.gov/pub/irs-trty/spain.pdf>; Andrus, *supra* note 42, at 844.

126. See U.S. Model, *supra* note 22, at art. 7.

127. See Jessica L. Katz, Charles T. Plambeck & Diane M. Ring, *Taxation of Foreign Persons' U.S. Income*, 908-2nd T.M. (BNA), at V.C.3.b(2) (stating that most U.S. treaty partners, along with the OECD, take the position that Article 7(2) of the OECD model treaty requires the recognition of interbranch interest expense of a bank, whereas the United States traditionally disagreed with this interpretation of the OECD treaty).

128. Cf. Peroni, *supra* note 64, at 396 (pointing out that the current U.S. source rules often allow income that is not subject to foreign taxation (for example, by reason of a U.S. income tax treaty) to be treated as foreign source income and thus inflate a taxpayer's foreign tax credit limitation).

129. See Andrus, *supra* note 42, at 844.

### III. EQUITY-BASED STANDARD FOR DEVISING SOURCE RULES

#### A. Overview, Basic Assumptions, and Preliminary Matters

To address the problems identified above, this part develops a benefits principles-based standard for devising source rules that has the potential to be adopted on a multilateral basis.<sup>130</sup> An internationally harmonized approach to sourcing income that is based on the connection to governmental benefits should result in a fair allocation of taxing jurisdiction among nations; this could replace the current patchwork of rules, which often produce incoherent and arbitrary results.<sup>131</sup> And a principled standard that is considered fair by a critical mass of countries could lead to internationally harmonized source rules.<sup>132</sup> In this regard, an important goal is that the allocation of tax jurisdiction via source rules or their equivalent be mutually agreeable,<sup>133</sup> so that source taxation does not result in either double taxation or non-taxation.<sup>134</sup>

This Part proceeds in two steps: first by establishing the case for using the benefits principle along with administrability as the appropriate principles for designing source rules, and second by formulating a standard for devising source rules that is based on the appropriate principles. Before doing so, a few assumptions and preliminary matters are in order.

First, it is assumed that countries will continue to exercise source taxation, as opposed to abandoning such in favor of exclusive residence

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130. *Cf. id.* at 856 (concluding that “to address the tax issues created by the changing economy, international consensus must be developed with regard to characterizations issues as well as source rules”).

131. *Cf. McIntyre, Tax Rules, supra* note 50, at 3–65 to 3–66 (pointing out that each country should receive a reasonable share of the global tax base pursuant to a fair negotiating process).

132. *See* Peggy B. Musgrave, *Sovereignty, Entitlement, and Cooperation in International Taxation*, 26 BROOKLYN J. INT’L L. 1335, 1345 (2001) (calling for the adoption of a formula via mutual international agreement that “generally is acceptable for reasons of fairness” in order to achieve international cooperation in the sharing of the tax base); *cf. Benshalom, supra* note 84, at 79 (stating that effective tax cooperation among nations can be facilitated where “it involves an organizing principle that all parties consider fair”); Rifat Azam, *E-Commerce Taxation and Cyberspace Law: The Integrative Adaptation Model*, 12 VA. J.L. & TECH. 5 (viewing an approach for taxing electronic commerce that divides the tax pie fairly as having the potential to gain international acceptance).

133. *See McIntyre, Tax Rules, supra* note 50, at 3–65 to 3–66 (stating that a goal of model source rules should be the allocation of taxing jurisdiction in some mutually agreeable manner); *cf. Andrus, supra* note 42, at 856 (calling for international consensus on source rules to address sourcing issues created by electronic commerce and other aspects of the changing economy).

134. *See McIntyre, Tax Rules, supra* note 50, at 3–65 to 3–66.

taxation. Second, it is assumed that countries will continue to adhere to the “single tax principle” — subjecting cross-border income to one tax — and thus attempt to avoid double taxation and non-taxation by employing either foreign tax credit or territorial systems.<sup>135</sup> Third, it is assumed that in allocating taxing rights over cross-border business and investment income, countries will continue to use the separate transactions method (source and transfer pricing rules), rather than applying formulary apportionment methods to a taxpayer’s aggregate net income.<sup>136</sup>

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135. See Reuven S. Avi-Yonah, *International Taxation of Electronic Commerce*, 52 TAX L. REV. 507, 517 (1997) [hereinafter Avi-Yonah, *Electronic Commerce*]. The single tax principle has been justified “on both theoretical and practical grounds.” Reuven S. Avi-Yonah, *Tax Competition, Tax Arbitrage and the International Tax Regime*, 61 BULL. INT’L TAX’N 130, 134 (2007). With regard to theory, a heavier tax on cross-border income as compared to domestic income would create an inefficient incentive to invest domestically; a lighter tax on cross-border income would create an inefficient incentive to invest abroad. *Id.* In addition, the non-taxation of cross-border income when compared to the taxation of domestic labor income can violate both horizontal and vertical equity. *See id.* From a practical perspective, double taxation of cross-border income would tend to stifle international investment, while non-taxation of such income can lead to the avoidance of domestic taxation by investing internationally, thereby eroding the national tax base. *Id.*

136. Recently, several notable commentators on international taxation have proposed using formulary apportionment to allocate tax jurisdiction over the income of related multi-national corporations. *See, e.g.*, Reuven S. Avi-Yonah, Kimberly A. Clausing & Michael C. Durst, *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, 9 FLA. TAX REV. 497, 498 (2009). While it is conceivable, it is not likely that formulary apportionment will replace the current system in the foreseeable future. *See* James J. Tobin, Barbara M. Angus, & David J. Canale, *Preserving and Protecting the Arm’s-Length Standard*, INT’L TAX MON., July 19, 2010 (asserting that the arm’s-length standard should continue to be at the center of the international tax system); *see also* Kleinbard, *Lessons, supra* note 84, at 66 (pointing out that without some form of multilateral cooperation, formulary apportionment poses a substantial risk of over or under taxation; concluding that “[i]t is difficult to imagine how a multilateral global formulary apportionment system can come to pass); Rosanne Altshuler & Harry Grubert, *Formula Apportionment: Is It Better Than The Current System and Are There Better Alternatives?*, 63 NAT’L TAX J. 1145, 1182–83 (2010) (concluding that formula apportionment and separate accounts distort behavior along different margins and that simulations indicate that the former has no clear advantages over the latter); Susan C. Morse, *Revisiting Global Formulary Apportionment*, 29 VA. TAX REV. 593 (2010) (questioning the benefits of the unilateral U.S. adoption of a destination sales-based formulary apportionment method for dividing global jurisdiction to tax corporate income). Consequently, this Article assumes the continued use of source and transfer pricing rules to allocate taxing rights over income among nations.

The harmonized source rules developed under the sourcing standard should be the same for countries' taxation of both in-bound transactions by nonresidents and out-bound transactions by residents.<sup>137</sup> Where countries use uniform source rules, but the rules for in-bound and out-bound transactions differ, either double taxation or non-taxation will result.<sup>138</sup> For example, assume that all countries adopted a rule that sourced service income based on the location of the recipient of the services for in-bound transactions and on the place of performing services for out-bound transactions. A Country A resident performs services in Country A for a company that is located in Country B. Under the in-bound source rule, the Country A resident would have Country B source income that is subject to tax in Country B because the recipient of the services was located there. However, under the out-bound source rule, Country A would treat the income as domestic source for purposes of calculating its resident's allowable foreign tax credit (assuming it uses a foreign tax credit system that includes a limitation based on the amount of foreign source income), because the services were performed in Country A. Consequently, the Country A resident may be prohibited from receiving a foreign tax credit against her Country A tax liability for the Country B tax, thus potentially resulting in double taxation. If the source rules were reversed, it could be that neither country would be taxing the income.

Finally, the standard should be used to devise source rules that form the basis for countries' exercise of taxing jurisdiction.<sup>139</sup> Thus, income that is

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137. See ALI PROJECT I *supra* note 14, at 348–49 (stating that “presumptively at least, the ‘inbound’ and ‘outbound’ source rules should be the same”); PETER A. HARRIS, CORPORATE/SHAREHOLDER INCOME TAXATION AND ALLOCATING TAXING RIGHTS BETWEEN COUNTRIES, 445–446 (1996) (stating that the only reference point in evaluating whether countries appropriately tax international income “is the symmetry of their own tax system”). Some commentators disagree with this, but they are approaching the issue of sourcing from the perspective of enhancing the welfare of U.S. individuals. See Shay, Fleming & Peroni, *Source Rules*, *supra* note 1, at 150–51. As mentioned above, the objective of this Article is to develop a sourcing standard that can be adopted multilaterally, which thus should refrain from taking into account particular countries' national interests. See *infra* note 223–225 and accompanying text.

138. See Andrus, *supra* note 42, at 843 (source rules that do not treat U.S. and foreign taxpayers the same will inevitably lead to double taxation or non-taxation).

139. Nevertheless, as under current law, certain countries, generally referred to as tax havens, may impose little or no tax on income over which they have jurisdiction to tax. Consequently, it is assumed that countries may continue to employ mechanisms designed to prevent their residents from avoiding current taxes on certain income that is allocated to tax haven corporations, such as the anti-deferral regimes used in the United States — (subpart F rules (I.R.C. §§ 951–965)) and the PFIC rules (I.R.C. §§ 1291–1298)). In addition, with the proposed sourcing

treated as domestic source with respect to a particular country would be subject to tax in the hands of a nonresident of that country;<sup>140</sup> unlike current U.S. law,<sup>141</sup> operative tax provisions will not prevent the taxation of income that is treated as domestic source. Likewise, income that is treated as foreign source would be nontaxable to a nonresident.<sup>142</sup> Similarly, it is contemplated that since there will be multilateral agreement on source via harmonized domestic rules, treaties would not generally alter the taxing rights of countries, although treaties may still affect to some degree the tax rates that apply to particular types of income.<sup>143</sup>

## B. Appropriate Principles for Sourcing Income

### 1. The Benefits Principle

As discussed earlier,<sup>144</sup> the source rules are used to determine the contours of countries' exercise of source taxation, that is, the taxation by a host country over nonresidents. Source rules also affect the scope of countries' exercise of residence taxation — the taxation by a country of its residents.<sup>145</sup> This effect, however, is derivative of source taxation. Countries that mitigate double taxation through foreign tax credit systems cede primary tax jurisdiction with respect to their residents over income that is viewed as properly subject to source taxation by host countries. Countries that use territorial systems that exempt foreign source income cede all tax jurisdiction over such income. Because the source rules define the scope of source

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approach, countries also may want to exercise residual tax jurisdiction over the foreign source portion of income derived by nonresidents from domestic activities. See *infra* note 287 and accompanying text.

140. Cf. ALI PROJECT Part I, *supra* note 14, at 115 (recommending that U.S. source income generally be subject to either U.S. net basis or gross basis taxation, although providing exceptions for certain items, including portfolio interest).

141. See, e.g., I.R.C. §§ 871(h), 881(c) (portfolio interest exemption).

142. Under current U.S. law, it is possible for a foreign person to be taxable on foreign source income. See I.R.C. §§ 864(c)(4), 882(a).

143. This may be warranted in order to ameliorate the excessive burdens of gross basis taxes where a taxpayer is likely to incur significant expenses in earning income — for example, interest income earned by a nonresident bank. See *supra* notes 73–75 and accompanying text. Of course, this could also be done through harmonized domestic legislation, but there may be reasons why countries may find the treaty process more appropriate for such provisions. See ALI PROJECT II, *supra* note 21, at 12–13 (stating that a source country may not want to forgo taxing income that is received by a resident of a tax haven country). With regard to the permanent establishment requirement for subjecting business income to source taxation, it may be advisable to retain the requirement, albeit in modified form. See *infra* note 342.

144. See *supra* notes 3–6 and accompanying text.

145. See *supra* notes 3–6 and accompanying text.

taxation, the principles that form the basis for source taxation should be used in formulating source rules.

It is widely accepted that source taxation is grounded on the benefits principle: a host country should have the right to tax a nonresident on income that benefits from host country government services, with the tax serving as a charge, of sorts, for these benefits.<sup>146</sup> A nonresident with investments or business activities in the host country benefits from numerous government activities, including those that give rise to infrastructure (physical, economic,

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146. See ALI PROJECT I, *supra* note 14, at 18; Lokken, *Intellectual Property*, *supra* note 57 at 239; Shay, Fleming & Peroni, *Source Rules*, *supra* note 1, at 90; Peggy B. Musgrave, INTERJURISDICTIONAL EQUITY IN COMPANY TAXATION: PRINCIPLES AND APPLICATIONS TO THE EUROPEAN UNION, IN TAXING CAPITAL INCOME IN THE EUROPEAN UNION 46, 52–53 (Sjibren Cnossen ed., 2000), reprinted in Michael J. Graetz, FOUNDATIONS OF INTERNATIONAL INCOME TAXATION 6 (2003); Avi-Yonah, *Electronic Commerce*, *supra* note 135, at 521; Graetz & Grinberg, *supra* note 76, at 569; Michael S. Kirsch, *The Role of Physical Presence in the Taxation of Cross-Border Personal Services*, 51 B.C. L. REV. 993, 1040 (2010) [hereinafter Kirsch, *Services*]; Mason, *supra* note 84, at 1553–54; Carlo Garbarino, *A Study of the International Tax Policy Process: Defining the Rules for Sourcing Income from Isolated Sales of Goods*, 29 HARV. INT'L L.J. 393, 394 (1988); William B. Barker, *An International Tax System for Emerging Economies, Tax Sparing, and Development: It Is All About Source!*, 29 U. PA. J. INT'L L. 349, 369–70 (2007); Benshalom, *supra* note 84, at 75; Steven A. Dean, *More Cooperation, Less Uniformity: Tax Deharmonization and the Future of the International Tax Regime*, 84 TUL. L. REV. 125, 161 & n.163 (2009) (referring to the benefits principle, used to assign tax jurisdiction, as being in some respects “the cornerstone of the modern income tax regime”); Kim Brooks, *Inter-Nation Equity: The Development of an Important but Underappreciated International Tax Policy Objective*, in TAX REFORM IN THE 21ST CENTURY 471, 492 (John G. Head & Richard Krever, eds., 2009); Lokken, *Source*, *supra* note 49 at 3; Jeffrey M. Colón, *Financial Products and Source Basis Taxation: U.S. International Tax Policy at the Crossroads*, 1999 U. ILL. L. REV. 775, 781; Edward A. Zelinsky, *Citizenship and Worldwide Taxation: Citizenship as an Administrable Proxy for Domicile*, 96 IOWA L. REV. 1289, 1293–94 (2011) (viewing source taxation as justified by the benefits principle on a theoretical level); cf. OECD, *E-Commerce* *supra* note 107, at 12, (referring to the benefits principle as a justification for source taxation; stating that source taxation may also serve to prevent nonresidents from capturing all of the economic rent derived from exploiting the host country’s resources); Mitchell A. Kane, *Risk and Redistribution in Open and Closed Economies*, 92 VA. L. REV. 867, 904–05 (2006) (stating that source taxation is typically grounded either upon the benefits principle or a theory of economic rents). For a recent discussion of the benefits principle for taxation in general, see James R. Repetti, *Democracy and Opportunity: A New Paradigm in Tax Equity*, 61 VAND. L. REV. 1129, 1135–38 (2008).

and legal), public safety, national security, and a skilled workforce.<sup>147</sup> Consequently, a key principle in determining whether an item of income should be sourced to a particular country is whether that country provides the taxpayer with governmental benefits that relate to the income.<sup>148</sup>

Closely aligned with the benefits principle basis for sourcing is the view that income should be sourced according to the location of the economic activities that give rise to the income.<sup>149</sup> The economic nexus basis for sourcing is best understood as a surrogate for the benefits principle — that is, the location of economic activities is where the taxpayer receives government benefits that justify a source tax.<sup>150</sup> Indeed, authorities referring to the economic nexus basis for sourcing income usually also refer to the place of legal protections as a basis for sourcing,<sup>151</sup> thus suggesting that it is the connection to government benefits that underlies the focus on economic activities. Importantly, economic nexus is an incomplete surrogate for the benefits principle in that by focusing on the location of economic activities conducted by taxpayer, it ignores government benefits provided by the taxpayer's country of residence that relate to the earning and enjoyment of income by the taxpayer.<sup>152</sup>

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147. See Shay, Fleming & Peroni, *Source Rules*, *supra* note 1, at 90; Mason, *supra* note 84, at 1553–54. For a more detailed discussion of these public benefits, see *infra* Part III.C.1.

148. See Colón, *supra* note 146, at 781 (“A designation of an item of income as U.S. (or foreign) source indicates that the United States (or a foreign country) is the country that has provided the primary benefits resulting in the earning of such income and therefore has primary tax jurisdiction.”); Lokken, *Source*, *supra* note 49 at 3–4 (proposing a conceptual framework for source determinations that “apportions a taxpayer’s ability to pay among jurisdictions in a way that reflects the governmental services and protections available to the taxpayer in profit-seeking activities”); cf. OECD, *E-Commerce*, *supra* note 107, at 14 n.20 (noting that the benefits principle, which provides a justification for source taxation, “can also be put forward as a principle for determining the source of the business profits”).

149. See *supra* notes 50–52 and accompanying text.

150. See Dean, *supra* note 146, at 162 & n.164 (indicating that the benefits principle underlies the recognized right of a country to tax income derived from economic activity occurring within its borders).

151. See TREASURY II, *supra* note 50, at 399.

152. Cf. Dean, *supra* note 146, at 161 n.162 (stating that the benefits principle also describes the relationship between a country and its residents and citing PEGGIE BREWER RICHMAN, *TAXATION OF FOREIGN INVESTMENT INCOME: AN ECONOMIC ANALYSIS* 23 (1963) for the proposition that a country has the right to tax the income and wealth of its residents based on the protection and services provided by the country). These residence country benefits are more fully described below. See *infra* notes 249–52 and accompanying text. It should be noted that Professor Lokken, in proposing a conceptual framework for source determinations that relies on the benefits principle, would not take into account consumer benefits received by

Source taxation may also be justified by the right of a host country to exact a charge for economic rents, or super-normal returns, realized by nonresidents through the use of a country's resources.<sup>153</sup> This basis for source taxation, however, should properly be viewed as merely a supplement to the benefits principle basis, as it would only permit a host country to tax super-normal returns. In both theory and practice, it is widely acknowledged that source taxation extends to all income that bears a sufficient economic connection to the host country, not just super-normal returns.<sup>154</sup>

At its core, the benefits principle underlying source taxation is an equitable principle. Nonresidents who earn income that profits from a country's government activities should be subject to source taxation on such income; otherwise, the burden for these government activities that benefit

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individuals that do not directly relate to the production of income. *See* Lokken, *Source*, *supra* note 49 at 3.

153. *See* OECD, *E-Commerce*, *supra* note 107, at 12; Robert A. Green, *The Future of Sourced-Based Taxation of the Income of Multinational Enterprises*, 79 CORNELL L. REV. 18, 30 (1993); Charles E. McLure, Jr., *Substituting Consumption-Based Direct Taxation for Income Taxes as the International Norm*, 45 NAT'L TAX J. 145, 148 (1992); Kane, *supra* note 140, at 904-05.

154. *See* Green, *supra* note 153, at 30 (stating that this argument does not justify source-based corporate income taxes); *but see* McLure, *supra* note 153, at 149 (considering the adoption of consumption-based direct taxation as the international norm, the effect of which would be source taxation of only economic rents for the most part). The power of governments to impose source taxes, or force majeure, is another explanation given for source taxation. *See* Green, *supra* note, 153 at 31-32. Even if force majeure were an explanation, it would apparently not provide a principle for designing source rules suitable for worldwide adoption. One commentator has offered a pragmatic justification for source taxation — that the source country is generally in the best position to enforce a tax on cross-border income. *See id.* Arguably, this possible justification for source taxation could provide a basis for designing sources rules, under which income could be sourced to the country that is able to monitor transnational income by requiring local firms and financial intermediaries to report and withhold on payments they make to nonresidents. However, basing source taxation and implementing source rules on a country's enforcement capabilities appears to go too far, in that tax collection can be protected even without source taxation of cross-border income by requiring the country in the better position to monitor cross-border income to report such income to the recipient's country of residence or to withhold tax subject to refunds upon demonstration that a residence country tax has been paid. *Cf.* GARY CLYDE HUFBAUER, U.S. TAXATION OF INTERNATIONAL INCOME: BLUEPRINT FOR REFORM 68-71 (1992) (recommending similar measures for a system that imposes residence-only taxation of portfolio income). Consequently, countries' enforcement capabilities should not provide the primary basis for designing multilateral source rules, although enforcement concerns should be a factor in formulating particular source rules. *See infra* Part III.C.3.b for a discussion of this latter point.

nonresidents would be borne by residents of that country alone.<sup>155</sup> Thus, an equitable sharing of the cost of government activities between nonresidents and residents is at the root of source taxation.

The equity basis underlying source taxation can be described as a form of inter-individual equity, because it requires the fair treatment of taxpayers — residents and nonresidents — who receive governmental benefits from a particular country.<sup>156</sup> It can also be described as inter-nation equity, a term that usually refers to the equitable sharing among nations of the taxation of cross-border business and investment income.<sup>157</sup> In any event, the normative basis for inter-nation equity, if any, would appear to rest on the theoretical foundation for inter-individual equity, since it is individuals that ultimately pay taxes.<sup>158</sup>

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155. See Shay, Fleming & Peroni, *Source Rules*, *supra* note 1, at 96–97 (“Domestic fairness requires that the costs of the U.S. government be borne both by (1) residents on the basis of ability to pay, and (2) nonresidents on the basis of an appropriate charge for the privilege of exploiting the U.S. market. To the extent that abandonment of source taxation relieves nonresidents of their charge, the tax burden belonging to nonresidents inevitably will shift to U.S. residents. A failure of nonresidents to contribute to the costs of government, would therefore, diminish, not enhance, domestic tax fairness.”); See Nancy H. Kaufman, *Fairness and the Taxation of International Income*, 29 *LAW & POL’Y INT’L BUS.* 145, 153 (1998) (referring to the conclusion of other commentators that under the benefit theory for source taxation “individuals who benefit equally from government, including nonresidents, should contribute to the host country’s cost of government”).

156. See Kaufman, *supra* note 155 at 153 (stating that most scholarship on residence and source taxation internationalizes inter-individual equity).

157. See *id.* at 153–54 (citing to writings by Peggy Musgrave and Richard Musgrave describing inter-nation equity in various ways: “an ‘equitable international distribution of the tax base,’” “an equitable division of the tax revenue between countries,” “an equitable ‘allocation of national gain and loss,’” “[t]he problem of tax shares in international business,” and “an equitable division of the ‘tax pie . . . among the treasuries of the various countries’”).

158. In examining whether tax competition among nations should be reconsidered in order to promote inter-nation equity, Professor Ring evaluated the normative basis for inter-nation equity in terms of inter-individual equity (“because it is the individuals for whom we are ultimately concerned”) and concluded that “to fit inter-nation equity into the current framework of inter-individual equity (premised on a legitimate nation-state and community) we can only endorse the ‘inter-nation version’ of inter-individual equity *if* in fact all of these individuals are members of a single community under one government — a global state.” Diane Ring, *Democracy, Sovereignty and Tax Competition: The Role of Tax Sovereignty in Shaping Tax Cooperation*, 9 *FLA. TAX REV.* 555, 587 (2009). Professor Ring does leave open the possibility in the future for a normative basis for inter-nation equity standing alone, based on an accepted theory of duty and obligations owed to others globally. See *id.* at 585, 587, 590.

The equity basis for source taxation may be complicated by the fact that some residents of a given country will be investing or doing business in other countries. Thus, it may be contended that one country's failure to tax a nonresident for the receipt of governmental benefits can be "offset" by the failure of the nonresident's country to tax the other country's residents when they receive host country governmental benefits. One response is that taxpayers with purely domestic business and investment activities would not benefit from another country's lack of source taxation: such taxpayers would bear the cost of home country governmental benefits received by nonresidents but would not take advantage of tax-free governmental benefits provided by other countries. Nonetheless, a further contention may be that resident taxpayers with purely domestic activities would not suffer from their home country's lack of source taxation over nonresidents because other home country residents with foreign income that is free of source taxation would then bear a greater residence country tax burden. This is because without the imposition of source taxation, there would be no occasion nor need for a home country to provide its residents with foreign tax credits or foreign income exclusions, respectively.<sup>159</sup> Thus, a home country would be taxing its residents with foreign income effectively as surrogates for the nonresidents receiving governmental benefits from the particular country. However, this argument assumes equal capital flows between countries, which would never be the case. If a given country's amount of nonresident investment or business activity exceeds the amount of foreign investment or business activity conducted by its residents, *i.e.*, is a net capital importer, then its residents with purely domestic activities would not experience a sufficient tax offset for its country's failure to exercise source taxation over nonresidents.

Notions of perceived equity bolster the equity basis for source taxation. Recently, some leading commentators on international taxation have put forth what they term as a new principle for structuring source taxation — the parity principle.<sup>160</sup> In applying this principle to U.S. source taxation, they assert that the U.S. income tax should treat businesses owned by foreign taxpayers no more favorably than comparably situated U.S.-owned businesses.<sup>161</sup> The basis for the parity principle is that residence taxation will lose legitimacy and efficacy if residents perceive that they are being more heavily taxed than nonresidents with equal amounts of income

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159. See Green, *supra* note 153, at 80 (pointing out that with international agreement on a residence-based tax system, the United States would collect more tax revenue from its residents with foreign source income because it would no longer yield to other countries the primary right to tax such income).

160. See Shay, Fleming & Peroni, *Source Rules*, *supra* note 1, at 110–11.

161. *Id.* at 111.

from the residence country;<sup>162</sup> thus, this principle rests on perceptual equity concerns (along with real equity concerns).<sup>163</sup> In applying the parity principle in examining a few source rules, the commentators refer to the access to the U.S. market, which they see as a product of government activities, as well as U.S. legal protections,<sup>164</sup> indicating that the benefits principle is at the core of their parity principle. Consequently, their work suggests that both real and perceptual equity concerns support the benefits-principle basis for source taxation.

## 2. *Effect of the Ability to Pay Principle*

In contrast to source taxation, residence taxation rests on a different equity basis than source taxation, this being the notion of a taxpayer's ability to pay.<sup>165</sup> Under residence taxation, the tax burden is allocated among taxpayers in a manner that reflects their relative abilities to pay.<sup>166</sup> Because a taxpayer's worldwide income is usually considered the proper gauge for measuring a taxpayer's ability to pay, and because the ability to pay principle suggests that tax rates should be progressive, residence taxation is generally implemented by imposing a progressive tax on a taxpayer's worldwide income.<sup>167</sup>

Although it may seem as though source taxation and residence taxation are quite distinct, this is not the case. First, source taxation, while founded on the benefits principle, can be viewed as having ability-to-pay attributes.<sup>168</sup> The source tax, similar to the residence tax, is determined by applying tax rates to a nonresident's domestic source income. Thus, no effort is made to approximate the value of the benefits received by the nonresident from the host country's government activities that relate to the nonresident's income, no doubt because it would be impossible to do so with any degree of

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162. *See id.*

163. Other scholars have pointed out the importance of perceptual equity. *See, e.g.,* Noël B. Cunningham & Deborah H. Schenk, *The Case for a Capital Gains Preference*, 48 TAX L. REV. 319, 368–69 (1993).

164. *See* Shay, Fleming & Peroni, *Source Rules*, *supra* note 1, at 91–92, 142–43.

165. *See* J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income*, 5 FLA. TAX REV. 299, 306–08 (2001) [hereinafter Fleming, Peroni & Shay, *Fairness*]. Besides equity, other considerations that are important in residence taxation include economic efficiency and administrability. *See id.* at 306–08 & n.14.

166. *See* Green, *supra* note 153, at 29.

167. *See id.*

168. *See* Lokken, *Intellectual Property*, *supra* note 57, at 239–40.

accuracy.<sup>169</sup> Instead, the amount of tax that is imposed on a nonresident's domestic source income appears to reflect the host country's determination of a fair allocation of the tax burden based on the relative abilities to pay of all taxpayers, with nonresidents judged only on the basis of their domestic source income.<sup>170</sup> This view is buttressed by the fact that the rates that apply to a nonresident's domestic source business income are often progressive in nature.<sup>171</sup> Thus, while the benefits principle forms the basis for, and defines the scope of, source taxation, the ability to pay principle appears to provide some role, at least in practice, in determining the amount of tax that is imposed on a nonresident's domestic source income.<sup>172</sup>

In addition, and of significance in determining principles for sourcing income, source taxation and residence taxation are related in that source taxation frustrates to an extent the ability to pay principle underlying residence taxation. It is standard practice, as well as an assumption of this Article,<sup>173</sup> that with source taxation, countries will relieve international double taxation either by allowing their residents a foreign tax credit or exempting certain foreign income from residence taxation. Where a foreign tax credit is allowed, the residence tax is reduced by the amount of the credit, whereas from the strict standpoint of measuring ability to pay, there should only be a deduction for foreign taxes, as is the case with other expenses of earning income.<sup>174</sup> And where a residence country employs an exemption system to relieve double taxation, the residence country ignores completely the exempt foreign income in measuring the resident's ability to pay. Consequently, source taxation effectively diminishes the ability of a

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169. See Mason, *supra* note 84, at 1585 (stating that it would be impossible to determine precisely the amount of government benefits received by taxpayers); Barker, *supra* note 146, at 370 (stating that there is no way to measure directly the benefit received; instead one should develop a tax base that reflects the benefit received).

170. See Lokken, *Intellectual Property*, *supra* note 57, at 239–40.

171. See, e.g., I.R.C. §§ 871(b), 882(a).

172. See Lokken, *Intellectual Property*, *supra* note 57, at 239–40. Whether this is correct as a normative matter is another issue. Some commentators are of the view that ability-to-pay considerations should not be used in connection with source taxation. Their reason is that ability to pay should be measured by reference to a taxpayer's total income and not just that income over which a country exercises taxing jurisdiction. See Shay, Fleming & Peroni, *Source Rules*, *supra* note 1, at 94–95. Nevertheless, these commentators endorse the determination of a nonresident's source tax liability by imposing graduated tax rates on a nonresident's domestic source, because it is a reasonable and practical measure of the host country government benefits received and it treats nonresidents in a nondiscriminatory manner versus residents. See *id.* at 95, 104.

173. See *supra* note 135 and accompanying text.

174. See Fleming, Peroni & Shay, *Fairness*, *supra* note 165, at 328; Ault & Bradford, *supra* note 1, at 41.

residence country to equitably allocate the costs of government activities among its residents on their respective abilities to pay.<sup>175</sup>

Based on this reason, some commentators call for an end to source taxation in favor of exclusive residence taxation.<sup>176</sup> Other commentators advocate for a modified source taxation approach under which passive income would be subject to exclusive residence taxation, but active income would continue to be subject to source taxation.<sup>177</sup> Those supporting the modified source taxation approach justify the passive/active income distinction by pointing to the fact that international passive income is often earned by individuals, for whom ability to pay taxation is geared, whereas international active income tends to be earned by corporations, for which the ability to pay principle is less relevant.<sup>178</sup> Because these proposals call for a reduction (or even elimination) of source taxation, they would obviously greatly affect the formulation of source rules.

The appropriateness of eliminating or reducing source taxation should be decided on the basis of the equitable principles involved. Source taxation promotes an equitable sharing of the costs of government among residents and nonresidents. Residence taxation advances the equitable allocation of the costs of government among residents based on their relative abilities to pay. Because source taxation frustrates residence taxation to an extent, the issue is which approach strikes the appropriate balance between these two competing types of equity.

Exclusive residence taxation simply goes too far in favor of ability-to-pay equity, by ignoring completely the benefits provided to nonresidents by the host country.<sup>179</sup> In addition, because exclusive residence taxation would result in more tax revenue for developed countries and less for

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175. See Shay, Fleming & Peroni, *Source Rules*, *supra* note 1, at 97. Some commentators appear to take the position that source taxation is objectionable under the ability-to-pay criterion not necessarily because it interferes with residence taxation, but because source taxation is itself a poor way to measure ability to pay as it only taxes a portion of a taxpayer's worldwide income and sometimes uses gross basis withholding taxes. See Graetz and Grinberg, *supra* note 76, at 570; Green, *supra* note 153, at 29.

176. See Green, *supra* note 153, at 29, 32.

177. See Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 TEX. L. REV. 1301 (1996) [hereinafter Avi-Yonah, *Simplification*].

178. See *id.* at 1310–17.

179. See MICHAEL J. GRAETZ, FOUNDATIONS OF INTERNATIONAL INCOME TAXATION 67–68 (2003) [hereinafter Graetz, FOUNDATIONS]; *cf.* Avi-Yonah, *Simplification*, *supra* note 177 at 1311 (stating that the ability-to-pay argument for exclusive residence taxation does not explain why the home country should have the only claim to tax cross-border income and that based on economic allegiance, both countries should have taxing rights).

developing countries, the latter would likely refuse to cooperate in such a system.<sup>180</sup> In any event, this Article assumes that countries will continue to exercise source taxation.<sup>181</sup>

While an approach that eliminates source taxation of passive income at least strikes a balance between the equitable principles involved, is it an appropriate one? Equitable determinations are fraught with value judgments,<sup>182</sup> and the same is true in deciding between competing notions of equity. There appears to be no correct answer here. The remainder of the Article assumes that countries will generally agree that the equitable notions underlying the benefits principle are more important than those supporting ability-to-pay taxation where these equitable notions conflict, and that the benefits principle should generally dictate the scope of source taxation for both passive and active income. However, under the proposed sourcing standard (which is discussed in the next section<sup>183</sup>), it would be possible to take ability-to-pay equity into account to some extent in determining the source of income,<sup>184</sup> this can be done by increasing the portion of income that is sourced to the country of residence due to ability-to-pay equity considerations.<sup>185</sup>

### 3. *Administrability*

Another principle that should guide the development of a sourcing standard is administrability.<sup>186</sup> It is important for source rules to operate in a clear fashion and refrain from requiring difficult factual determinations on a case-by-case basis.<sup>187</sup> Both taxpayers and tax administrators need clarity and

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180. See Avi-Yonah, *Simplification*, *supra* note 177 at 1313–14.

181. See *supra* text accompanying note 135.

182. Indeed, some would assert that for purposes of the ability-to-pay criterion, a resident of a country who has income from foreign sources is not similarly situated to a resident with income only from domestic sources. See Ault & Bradford, *supra* note 1, at 41 (referring to these assertions).

183. See *infra* Part III.C.

184. Cf. Julie Roin, *Competition and Evasion: Another Perspective on International Tax Competition*, 89 GEO. L.J. 543, 588–89 (2001) (in arguing for a system where the United States exempts foreign income from taxation, contending that the United States may be justified in imposing some tax on such income because of the government benefits provided by the United States to U.S. corporations with respect to such income, along with the notion that “U.S. corporations may be expected to contribute to the redistributive social benefits decided upon by the nation’s electorate”).

185. See *infra* note 312 and accompanying text.

186. See ALI PROJECT I, *supra* note 14, at 19; TREASURY II, *supra* note 50, at 399; McIntyre, *Tax Rules*, *supra* note 50, at 3–66 to 3–67.

187. TREASURY II, *supra* note 50, at 399; see McIntyre, *Tax Rules*, *supra* note 50, at 3–66; Andrus, *supra* note 42, at 842.

minimal uncertainty in performing their respective compliance and enforcement tasks. This is particularly so where the source of income determines whether a payer of an item is required to withhold in order to collect tax on an in-bound transaction.<sup>188</sup>

To this end, the sourcing standard, and the rules devised thereunder, should avoid overly refined approaches aimed at absolute precision. In particular, while the sourcing standard (discussed in the next section) will call for the division of an item of income among different sources where appropriate,<sup>189</sup> this will generally be done using a bright line approach in order to provide clear and predictable source rules.<sup>190</sup> Such an approach is further supported by the equity basis that underlies the benefits principle, which, as noted above, is somewhat imprecise given the value judgments involved.<sup>191</sup>

An aspect of administrability is that a source tax must be enforceable.<sup>192</sup> It would make little sense in designating income as domestic source for purposes of a country's exercise of source taxation over nonresidents if the tax cannot be enforced because the nonresidents are not physically present in the host country and collection of the tax through withholding would not be feasible. Accordingly, enforcement should be an important consideration under the standard for devising source rules.<sup>193</sup>

#### 4. *Inappropriate Principles in Developing the Sourcing Standard*

The preceding subsections have determined that connection to government benefits and administrability are principles that should guide the development of a standard for sourcing income. This subsection demonstrates why other principles should not be used in developing the sourcing standard, because they either do not appropriately relate to sourcing income or are not suitable for crafting source rules intended for multilateral adoption.<sup>194</sup>

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188. See McIntyre, *Tax Rules*, *supra* note 50, at 3–66; cf. ALI PROJECT I, *supra* note 14, at 36 (referring to withholding complications as a reason for not dividing the source of rental income where a taxpayer had produced the leased property).

189. See *infra* notes 267–70 and accompanying text.

190. Cf. Andrus, *supra* note 42, at 842 (noting the administrative benefits of source rules that rely on line drawing).

191. See *supra* notes 155–56, 182 and accompanying text.

192. See Shay, Fleming & Peroni, *Source Rules*, *supra* note 1, at 115.

193. See Walker, *supra* note 47, at 6, 30.

194. In this regard, the principles underlying treaty provisions that reduce or eliminate source taxation on investment income can be viewed as either consistent with, or supplemental to, an approach for sourcing income that focuses on the countries that provide the taxpayer with public benefits relating to the income. To

a. *Capital Export Neutrality and Capital Import Neutrality*

Capital export neutrality (CEN) and capital import neutrality (CIN) should be examined for their potential for providing principles for sourcing. While these are the key neutrality policies generally thought to govern the structure of cross-border taxation,<sup>195</sup> they apparently have little to offer in developing the sourcing standard.<sup>196</sup>

CEN is satisfied when a resident pays the same total of resident country and foreign taxes regardless of whether the income is earned within or without the country of residence.<sup>197</sup> In this situation, a resident's decision to invest in the residence country or abroad is unaffected by the tax consequences in the residence and foreign countries.<sup>198</sup> Instead, the decision is dictated by pre-tax returns.<sup>199</sup> Because the location of investments is not affected by the income taxes, economists generally view CEN as essential for worldwide economic efficiency.<sup>200</sup>

Whether CEN is achieved does not depend on the method used for dividing tax jurisdiction among countries. For example, CEN would be satisfied if all countries used residence taxation exclusively.<sup>201</sup> Alternatively, CEN would exist with source taxation, provided that residence countries taxed domestic and foreign income the same and allowed for an unlimited and refundable foreign tax credit.<sup>202</sup> (It should be noted that apparently no

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the extent that these treaty provisions reflect the view that the source country's claim to tax investment income is relatively weak (*see supra* notes 76–78 and accompanying text), they are conceptually consistent with the benefits principle; nevertheless, an evaluation of the related public benefits under the standard proposed in this Article may lead to different allocations of tax jurisdiction than that currently provided in treaties. To the extent that the treaty limitations on taxing investment income aim to prevent excessive source taxation, this principle can co-exist with harmonized source rules founded primarily on the benefits principle, by allowing for treaties to continue reducing the source tax rate on certain income where appropriate to achieve this objective. *See supra* notes 74–75 and accompanying text.

195. *See* Graetz, *Inadequate Principles*, *supra* note 97, at 270–71.

196. *See* OECD, *E-Commerce*, *supra* note 107, at 13 (concluding that the policies of CEN or CIN do not depend in practice on whether a country should have source taxation rights over particular income); Shay, Fleming & Peroni, *Source Rules*, *supra* note 1, at 108–10 (stating that CEN and CIN apply without regard to the division of tax revenue between source and residence countries; concluding that the efficiency criterion offer little help in the design of source taxation).

197. *See* CHARLES H. GUSTAFSON, ROBERT J. PERONI & RICHARD CRAWFORD PUGH, *TAXATION OF INTERNATIONAL TRANSACTIONS* 20 (2011).

198. *See id.*

199. *See id.*

200. *See* Graetz, *Inadequate Principles*, *supra* note 97, at 270.

201. *See* Shay, Fleming & Peroni, *Source Rules*, *supra* note 1, at 108.

202. *See id.*

country allows for an unlimited foreign tax credit<sup>203</sup>). On the other hand, CEN is not satisfied where a residence country uses a territorial system that exempts foreign income (assuming that foreign tax rate differs from the rate applied by the residence country on domestic source income), and this would be true regardless of how income is sourced for these purposes. Thus, with source taxation, whether or not CEN is satisfied depends primarily on methods used by resident countries for mitigating double taxation.<sup>204</sup> Nevertheless, CEN does support measures to reduce opportunities for cross-crediting, so that taxpayers will not have a tax incentive to invest in activities generating low-taxed foreign income as opposed to domestic income.<sup>205</sup> And, as discussed above,<sup>206</sup> a way of combating cross-crediting is to treat income as domestic source where a foreign country is not expected to tax the income. However, as pointed out below,<sup>207</sup> this expected-to-tax principle is not relevant in designing source rules intended for multilateral adoption by countries.<sup>208</sup>

CIN exists when the total tax that is paid on income earned in a country is determined without regard to the residence of the taxpayer.<sup>209</sup> Thus, CIN requires that all firms operating in a particular country be taxed at the same rate, whether the firms are domestically or foreign owned.<sup>210</sup> Where CIN holds, the worldwide allocation of savings is efficient because all savers receive the same after-tax returns.<sup>211</sup>

Upon initial examination, it would seem that similar to CEN, CIN is concerned only with the overall structure of international taxation. Thus, it is often stated that CIN would exist where countries employed territorial tax regimes that exempted foreign source income.<sup>212</sup> Under such a structure, only the source country would be taxing income from activities or investments within a given country, thus resulting in the same level of taxation for all taxpayers with income from that country.

On closer inspection, however, CIN does have something to say about the design of source rules. For CIN to exist, source countries and residence countries must apply the same source rules in determining the

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203. See *id.*; Graetz, FOUNDATIONS, *supra* note 179, at 27.

204. See Shay, Fleming & Peroni, *Source Rules*, *supra* note 1, at 109.

205. See Graetz, *Inadequate Principles*, *supra* note 97, at 271.

206. See *supra* notes 60–63 and accompanying text.

207. See *infra* Part III.B.4.b.

208. Moreover, cross-crediting can also be addressed by having separate foreign tax credit limitations for different categories of foreign source income, as contained in section 904(d). See Gustafson, Peroni & Pugh, *supra* note 197, at 413–23.

209. See *id.* at 21.

210. See *id.*

211. See Graetz, *Inadequate Principles*, *supra* note 97, at 271.

212. See *id.*

income to tax and exempt, respectively. Moreover, even with the uniform source rules, CIN would be violated if residence-based source rules were used. For example, assume that all countries sourced income from electronic commerce according to the residence of the taxpayer rather than the location of the sales activity or the destination of the items sold. Under this rule, sales by e-commerce sellers would be treated as domestic source for purposes of residence country taxation and exempt income for purposes of source taxation. Further assume that Country A imposes a 40 percent tax, Country B imposes a 30 percent tax, and Country C imposes a 20 percent tax. In these circumstances, a resident of Country C who is selling goods electronically into Country C would be taxed at 20 percent (the Country C rate), whereas a Country B resident performing the same activity would be taxed at 30 percent (the Country B rate). Assume that for both sellers all activities related to these electronic sales (such as maintaining a web site) occur in Country A. Thus, CIN is violated because the two sellers are not subject to the same tax on income that is earned through performing electronic sales activities in Country A and accessing the Country C market.<sup>213</sup> Consequently, CIN dictates that residence-based methods not be used to source income. However, as to whether the income should be sourced according to the location of the seller's activities or the location of the market (or a combination of both), CIN provides no guidance: as long as all countries apply the same source rule, taxpayers resident in different countries will be subject to the same rate of taxation with respect to operations in the same country or countries.

While CIN does provide some guidance for designing source rules, CIN is not the generally accepted neutrality standard<sup>214</sup> and consequently does not seem to be an appropriate guide for crafting source rules intended for multilateral adoption by countries.<sup>215</sup> Economists generally favor CEN over CIN because distortions in the investment locations are considered to be more costly than distortions in the savings allocation<sup>216</sup> (and it is practically

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213. See *infra* note 244–48 and accompanying text for a discussion of sourcing income based on accessing a country's market.

214. See Jane G. Gravelle, Cong. Research Serv., *Reform of U.S. International Taxation: Alternatives 7* (2010) (concluding that “capital import ‘neutrality’ is not neutral at all”).

215. Moreover, commentators have asserted that CIN has little or no relevance to the taxation of portfolio income, because taxing such income has no effect on the abilities of companies from different nations to compete against one another in a particular country. See Graetz & Grinberg, *supra* note 76, at 558–59.

216. See Graetz, *Inadequate Principles*, *supra* note 97, at 272. Moreover, as a practical matter, CIN is often rejected as an objective compared to CEN and national neutrality, given that many national policies of individual countries affect the return to savings. See James R. Hines, Jr., *Reconsidering the Taxation of Foreign Income*, 62 TAX L. REV. 269, 273–74 (2009). Nevertheless, economists may still

impossible to achieve CEN and CIN simultaneously).<sup>217</sup> Consequently, it is unlikely that countries would generally agree to adhere to CIN, which would be necessary for them to want to use it as a principle for designing source rules. For these reasons, CIN should not inform the development of the sourcing standard.<sup>218</sup>

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advocate territorial taxation based on a “second best” efficiency argument, as well as asserted simplicity and revenue raising benefits. *See* Gravelle, *supra* note 214, at 13–14 (referring to proposals advancing these arguments, but not subscribing to such views).

217. To do so would require uniform income tax bases and tax rates for all countries, or a worldwide government. *See* Graetz, *Inadequate Principles*, *supra* note 97, at 272.

218. Capital ownership neutrality (CON), a relatively recent neutrality policy, should also be considered for providing principles for developing the sourcing standard. CON requires that international tax rules not distort the identities of the owners of capital. *See* Gustafson, Peroni & Pugh, *supra* note 197, at 22 (citing to Mihir A. Desai & James R. Hines, Jr., *Evaluating International Tax Reform*, 56 NAT’L TAX J. 487 (2003)). According to its proponents, CON can be achieved if all countries adopted territorial tax systems. *See* Kleinbard, *Lessons*, *supra* note 84, at 8 & n.4; Gustafson, Peroni & Pugh, *supra* note 197, at 22. Alternatively, CON can be met if all countries adopted worldwide tax systems with foreign tax mechanisms. *See* Kleinbard, *Lessons*, *supra* note 84, at 8 n.4; Gustafson, Peroni & Pugh, *supra* note 197, at 22. In short, CON calls for conformity among countries in the method of double tax relief. *See* Gustafson, Peroni & Pugh, *supra* note 197, at 22; cf. Mitchell A. Kane, *Ownership Neutrality, Ownership Distortion, and International Tax Welfare Benchmarks*, 26 Va. Tax Rev. 53, 73–78 (2006) [hereinafter Kane, *Ownership*] (characterizing the prescription of CON in this fashion but not agreeing that non-mixed systems for providing double tax relief necessarily result in ownership efficiency). CON would appear to offer no principles for the design of multilateral source rules for use in either worldwide or territorial tax systems. This is because with worldwide tax systems coupled with foreign tax credit mechanisms, CON should be satisfied regardless of particular source rules. With territorial tax systems, CON should be satisfied as long as countries use uniform source rules. And, unlike the case for achieving CIN, it should not matter that such source rules employ residence-based sourcing approaches, as the key in achieving CON is the global consensus in the form of double tax relief. Moreover, even if CON did provide principles for developing multilateral source rules, like CIN, CON does not appear to be the generally accepted neutrality standard. *See* Gravelle, *supra* note 214, at 10 (“In light of the many ways in which the efficiency costs of capital ownership non-neutrality are unlikely to be significant compared to location distortions, it seems questionable to use meeting this standard of neutrality to evaluate tax reform changes.”); Kane, *Ownership*, *supra*, at 56 (arguing that CON is not an appropriate benchmark for determining international tax policy given the many factors that distort ownership patterns).

b. *Expectation that Another Country Will Be Taxing the Income*

As mentioned previously, another principle that is sometimes used to source income is whether it is expected that other countries will be taxing the income.<sup>219</sup> The concern underlying this principle is international under taxation. That is, if income is included in calculating a residence country's foreign tax credit limitation, but the income is not taxed by another country, the taxpayer would be able to cross-credit excess foreign tax credits on other foreign income against the pre-credit residence country tax on the income, thus effectively resulting in no or reduced overall tax on the income.<sup>220</sup> Similarly, if the residence country uses a territorial system, exempting income that is not taxed by another country would mean that no country is taxing the income.

The expected-to-tax principle is simply not relevant to the design of source rules in light of the following objectives of this Article — that the sourcing standard should produce source rules that are the same for countries' taxation of both in-bound transactions by nonresidents and out-bound transactions by residents, and that the source rules form the basis for countries' exercise of taxing jurisdiction. With the same source rules being applied by countries for taxing inbound and outbound transactions, the concern that underlies the expected-to-tax principle should not be present: income that is treated as foreign source for purposes of a taxpayer's home country foreign tax credit will be treated as domestic source and thereby be taxable by the host country.<sup>221</sup> Consequently, the expected-to-tax principle should be discarded in the design of multilateral source rules.<sup>222</sup>

c. *National Interests*

Finally, the national interests of particular countries should not be considered as relevant factors in developing the sourcing standard. In this

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219. See *supra* notes 60–65 and accompanying text.

220. See *supra* note 62 and accompanying text.

221. Of course, even with the general adoption of the sourcing scheme proposed by this Article, there will always be outlier countries. However, assuming that they are in the distinct minority, then in the vast majority of cases the concern underlying the expected-to-tax principle would not be present (because the vast majority of countries will be using consistent rules), and thus this principle need not be used in formulating source rules. If the proposed sourcing approach is not generally adopted, then it should not be used because of the high degree of double taxation and non-taxation that is likely to result. See *infra* notes 333–35 and accompanying text.

222. See *supra* note 88 for problems under current law with source rules based on this principle.

regard, some prominent commentators assert that U.S. national interests should dictate the structure of U.S. international income tax rules.<sup>223</sup> Fostering national interests may be a proper consideration in contexts where it is not critical whether countries use harmonized approaches for taxing international income. For example, it would appear that no great harm results where some countries tax their residents on the basis of worldwide income subject to the allowance of foreign tax credits, while other countries employ exemptions systems under which certain foreign income is excluded from home country taxation. Consequently, in deciding among these overall structures for taxing international income, it would appear that countries may appropriately take into account national concerns such as the economic well-being of their own residents. However, where source rules vary among countries, there is the potential for double or under taxation. For this reason, this Article seeks to develop rules that are suitable for international acceptance,<sup>224</sup> and universal agreement will likely not be reached on source rules that are designed to serve the national interests of one or more nations.<sup>225</sup>

Accordingly, source rules suitable for multilateral adoption should avoid features aimed at promoting national interests, such as the title passage rule for inventory sales<sup>226</sup> and the portfolio interest exemption.<sup>227</sup> It may be

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223. See Graetz, *Inadequate Principles*, *supra* note 97, at 277–82 (framing the inquiry as what international income tax rules will enhance the economic well-being of U.S. citizens and residents); Graetz & Grinberg, *supra* note 76, at 538 (asking what income tax policy for taxing foreign portfolio investments serves the United States' interest); Shay, Fleming & Peroni, *Source Rules*, *supra* note 1, at 97–98 (in evaluating the structure of U.S. source taxation, asserting that “the primary obligation of U.S. tax policy is to improve the well-being . . . of U.S. individuals”).

224. See Musgrave, *supra* note 132, at 1344 (calling for cooperative rules among nations for the division of the tax base and tax rates); OECD, *E-Commerce*, *supra* note 107, at 25 (stressing the need for universal agreement of rules for allocating taxing rights over business profits in order to prevent double taxation or non-taxation).

225. *Cf.* Musgrave, *supra* note 132, at 1348 (noting that the national interests of countries may conflict with each other).

226. See *supra* note 32 and accompanying text. In this regard, commentators assert that the foreign tax credit and the source rules used for purposes of limiting the credit should be focused on mitigating the double taxation of foreign income and “should not be designed to subsidize foreign investment, favor or disfavor particular types of investment, or serve nonrevenue raising foreign policy objectives.” See Shay, Fleming & Peroni, *Source Rules*, *supra* note 1, at 149. Commentators have used tax expenditure analysis to demonstrate that the title passage rule as applied to U.S. export sales is an inappropriate and ineffective subsidy for such sales activities; these commentators accordingly recommend that the title passage rule for export sales be repealed, and that the source of income from export sales be determined using an approach that more clearly reflects the location

contended that such deviations from the benefits principle whereby countries give up tax revenue<sup>228</sup> in order to promote national interests are benign from the standpoint of achieving universal agreement: countries not employing such features may simply not care because the effect would be under-taxation borne by another country as opposed to potential double taxation of a country's residents. However, other countries may object because such measures may harm their own national interests — for example, the title passage rule may provide a U.S. exporter with a competitive advantage vis a vis companies operating in the importing country. Similarly, while the portfolio interest exemption stimulates the provision of foreign capital,<sup>229</sup> capital-importing countries, in particular developing nations, stand to lose tax revenue to capital-exporting countries (i.e., developed nations) from source tax exemptions for interest and other types of portfolio income.<sup>230</sup>

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of the underlying economic activities. See J. Clifton Fleming, Jr. & Robert J. Peroni, *Reinvigorating Tax Expenditure Analysis and Its International Dimension*, 27 VA. TAX REV. 437, 551–61 (2008).

227. See *supra* note 21 and accompanying text. Other commentators also have proposed repealing the portfolio interest exemption, albeit for reasons that differ from those advanced in this Article. See Reuven S. Avi-Yonah, *Memo to Congress: It's Time to Repeal the U.S. Portfolio Interest Exemption*, 17 TAX NOTES INT'L 1817 (1998) (proposing that Congress repeal the portfolio interest exemption and instead enact a high withholding tax “on interest and other deductible payments to nonresidents” that would “be completely refundable on proof that the income . . . has been reported to the tax authorities” in the beneficial owner's country of residence; basing this proposal on the assertion that the factors that led to the enactment of the portfolio interest exemption no longer exist and that the exemption has led to the situation where most cross-border portfolio income is not being taxed by any jurisdiction, which is “unacceptable from an efficiency [or] equity perspective”); Michael J. McIntyre, *Guidelines for Taxing International Capital Flows: The Legal Perspective*, 46 NAT'L TAX J. 315, 317 (1993) [hereinafter McIntyre, *Guidelines*] (recommending that countries harmonize their withholding taxes on capital income at some positive rate and that the United States should take the first step towards this end by imposing a low-rate withholding tax on all interest payments; basing this proposal on the need to mitigate competitive pressures that undermine countries' imposition of income taxes and to raise revenue).

228. With the title passage rule, the United States is surrendering some residence taxation; with the portfolio interest exemptions, countries are surrendering some source taxation.

229. See *supra* notes 70–72 and accompanying text. Cf. Peter R. Merrill, et al, *Tax Treaties in a Global Economy: The Case for Zero Withholding on Direct Dividends*, 5 TAX NOTES INT'L 1387, 1388–89 (1992) (“[I]t generally is in every country's self interest to seek reciprocal elimination of withholding taxes.”).

230. See Michael J. Graetz & Michael M. O'Hear, *The “Original Intent” of U.S. International Taxation*, 46 DUKE L.J. 1021, 1033–34 (1997) (“Capital-exporting and capital-importing nations have conflicting financial interests: capital

And developing nations usually struggle between their tax revenue and foreign capital needs.<sup>231</sup> Thus, countries not favoring source exemptions for portfolio income may well object if the sourcing standard permits such exemptions, because these countries would then be at a competitive disadvantage in attracting foreign capital if they were to impose a source tax on portfolio income.<sup>232</sup> Moreover, permitting deviations from the benefits principle sets a precedent whereby countries may feel justified in varying their source rules where it suits their national interests, and some such measures may indeed result in instances of double taxation, thereby frustrating the goals of a universal sourcing standard.<sup>233</sup>

### C. Standard for Sourcing Income

The previous section has determined that the sourcing standard should be developed according to the following two principles: (i) sourcing income based on the countries that provide the taxpayer with public benefits

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importers have the most to gain from taxation at source, capital exporters from taxation of residents.”).

231. Keinan, *supra* note 72, at 66; see Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573, 1639–48 (2000) [Hereinafter Avi-Yonah, *Globalization*]. In this regard, commentators have warned that “[t]he resulting fiscal sacrifice [by developing countries from source tax exemptions] is likely to exceed by far the potential benefits resulting from new investment capital.” Lee A. Sheppard, *News Analysis: Revenge of the Source Countries, Part III: Source as Fiction*, 40 TAX NOTES Int’l 219, 224 (2005) (quoting from a report given by Angel Schindel and Adolfo Atchabahian at the September 12–16, 2005, International Fiscal Association World Congress in Buenos Aires, Argentina). Consequently, there is “a growing awareness that the sensible approach for developing countries is to withhold” tax on payments of portfolio income to foreign investors. *Id.*; see Cockfield, *supra* note 84, at 176 (pointing out that many developing nations prefer the provisions contained in the United Nations model tax treaty, which enhance source taxation); *cf.* OECD Model 2008, *supra* note 78, at Positions on Article 10 (Dividends) and Its Commentary, Positions on Article 11 (Interest) and Its Commentary, Positions on Article 12 (Royalties) and Its Commentary (several developing countries reserving their positions on deviating from the OECD treaty rates for dividends, interest, and royalties); *but cf.* Keinan, *supra* note 72, at 676 (contending that although residency taxation of financial transaction income “would shift revenue from developing countries to developed countries in the short-run,” it would benefit developing countries in the long-run).

232. With only some countries taxing portfolio income, it can be expected that most of the tax would be shifted to the borrower in the form of higher interest payments. See McIntyre, *Guidelines*, *supra* note 227, at 317.

233. For example, a country that wants to curb imports may enact a source rule that results in more domestic source income than that prescribed by the multilateral sourcing standard.

that relate to the income and (ii) administrability. This section uses these principles to develop a standard that can be used to derive particular source rules. As a first step in developing the standard, it is important to describe in some detail the types of public benefits that countries provide.

*1. Categorizing and Describing Governmental Benefits that Relate to Income*

Taxpayers receive numerous governmental benefits that relate to their earning and enjoyment of income. The locations where such governmental benefits are provided can be grouped into three categories: the situs of the activities giving rise to income; the destination of the property, capital, or services giving rise to income; and the residence of the person receiving income. Each of these is examined below.

*a. Countries Where Taxpayer Conducts Activities*

Numerous public benefits arise from government services that are provided in countries where taxpayers conduct income-producing activities. Included among these public benefits are physical infrastructure (e.g., roads and telecommunications), economic infrastructure (e.g., banking systems), legal infrastructure (e.g., court systems and regulatory agencies), public safety, national security, and a skilled workforce.<sup>234</sup> These products of government activities are either essential for, or contribute greatly to, the capacity of taxpayers to carry on activities in the particular country. As discussed previously,<sup>235</sup> the receipt of these government benefits justifies a source tax, and thus the location of these benefits should serve as a basis for sourcing income. Indeed, several of the current source rules determine the source of income based on the location of the economic activities giving rise to the income, which can be viewed as a surrogate for the location of the public benefits provided; these include the rules for sourcing service income<sup>236</sup> and manufacturing income.<sup>237</sup>

*b. Countries in Which Taxpayer Provides Property, Capital, or Services*

Where a taxpayer provides property, capital, or services into a country, the country of destination is providing the taxpayer with governmental benefits that relate to the earning of income. This is most

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234. See Shay, Fleming & Peroni, *Source Rules*, *supra* note 1, at 90.

235. See *supra* Part III.B.1.

236. See *supra* note 29 and accompanying text.

237. See *supra* note 34 and accompanying text.

easily understood in the form of legal protections provided by a destination country to a taxpayer in connection with royalties received for licensing patents, copyrights, or other intangibles for use in that country.<sup>238</sup> In this regard, the source rules typically source royalty income based on the location of the legal protections.<sup>239</sup> Destination countries provide other public benefits to taxpayers as well. For example, when a taxpayer is providing capital to a corporation, both the country (or countries) where the corporation conducts activities as well as the country under whose laws the corporation is formed are providing benefits that contribute to the taxpayer's ability to receive dividend income and stock gains; the former country provides benefits in support of the corporation's activities and the latter country provides the legal infrastructure that protects and regulates the taxpayer's investment in the corporation.<sup>240</sup> Current U.S. law recognizes both types of public benefits in sourcing dividend income, with dividends generally sourced according to the corporation's country of incorporation, but with exceptions that look to the place of substantial business activity conducted by the company.<sup>241</sup> Similarly, a taxpayer who loans money indirectly profits from the public benefits received by the borrower in connection with the borrower's income-producing activities, which provide the borrower with funds to pay interest to the taxpayer.<sup>242</sup> The current U.S. source rule is generally in accord with this view, as it sources interest income based on the residence (in the case of non-corporate borrowers) or country of incorporation (in the case of corporate borrowers) of the debtor, unless the debtor has substantial business activities or a banking branch outside its country of residence or incorporation.<sup>243</sup>

In addition, the country of destination provides significant public benefits by performing the governmental services essential for establishing a market for a taxpayer's goods and services.<sup>244</sup> The market in any country

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238. See ALI PROJECT I, *supra* note 14, at 45; Shay, Fleming & Peroni, *Source Rules*, *supra* note 1, at 143; Lokken, *Intellectual Property*, *supra* note 57, at 240–41.

239. See *supra* notes 25–26 and accompanying text.

240. See ALI PROJECT I, *supra* note 14, at 63.

241. See *supra* notes 19–20 and accompanying text.

242. Cf. Lokken, *Source*, *supra* note 49, at 7 (stating that under a benefits-based model for sourcing income, “interest originates where the borrower utilizes the borrowed funds because governmental services and protections at that location are central to the success of the borrower’s venture, which generates the capacity to pay interest on the loan”); ALI PROJECT I, *supra* note 14, at 67 (stating that the general principle under the current source rules for interest appears to be that the interest is sourced in the country that is reasonably presumed to be the place where the borrower derives the income or wealth that funds the interest payments).

243. See *supra* notes 17–18 and accompanying text.

244. See Shay, Fleming & Peroni, *Source Rules*, *supra* note 1, at 91; Avi-Yonah, *Electronic Commerce*, *supra* note 135, at 540; cf. ALI PROJECT I, *supra* note

could not exist without the necessary physical, economic, and legal infrastructure, and this is largely a result of governmental functions.<sup>245</sup> And by accessing a country's market through the sale of goods and services, a taxpayer is benefiting from these governmental activities, thus justifying a source tax to some degree on the income earned. While current U.S. law does not appear to recognize market access as a basis for sourcing income,<sup>246</sup> several leading commentators advocate that the United States should tax nonresidents as a charge for exploiting the U.S. market,<sup>247</sup> and other notable analysts view market access as a legitimate basis for exercising source taxation in general.<sup>248</sup>

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14, at 20 (stating that it might be appropriate to source income from the sale of inventory in the country in which the purchaser is located, because it is the country that "has provided the market for the property sold").

245. See Shay, Fleming & Peroni, *Source Rules*, *supra* note 1, at 91; *cf.* OECD, E-Commerce, *supra* note 107, at 14 (some members of the Technical Advisory Group studying the taxation of electronic commerce concluding that source taxation of a supplier not physically present in a market country is justified because the business profits derive partly from the use of the country's infrastructure, such as "means of transportation (such as roads), public safety, a legal system that ensure the protection of property rights and a financial infrastructure").

246. An exception to this may be the source rule for international communications income that is earned by U.S. persons, which treats 50 percent of such income as foreign source, possibly because the U.S. person is viewed as having accessed a foreign country's market by transmitting communications or data to that country. See I.R.C. § 863(e). While not based on the market access rationale, the title passage rule that applies under U.S. law for inventory sales can produce a source designation that is consistent with a market access approach. For example, where inventory is sold into a foreign country with title passing to the buyer in that country, the income will be foreign source. Of course, sales into the foreign country can also generate U.S. income if title to the goods passes in the United States. In any event, simply selling inventory into a country is not likely to result in a source tax in the absence of some other business activity in that country (and possibly a fixed place of business if a treaty applies). See *supra* notes 36-38 and accompanying text.

247. See Shay, Fleming & Peroni, *Source Rules*, *supra* note 1, at 91.

248. See Avi-Yonah, *Electronic Commerce*, *supra* note 135, at 540; *cf.* Graetz, *Inadequate Principles*, *supra* note 97, at 299 (stating that countries that supply only a market for goods and services may have a basis for exercising source taxation). In this regard, the OECD Technical Advisory Group that was established to address the taxation of electronic commerce could not reach an agreement as to whether or not a supplier that is not physically present in a country may be viewed as using that country's economic and legal infrastructure so as to justify source taxation of a portion of the enterprise's profits. See OECD, E-Commerce, *supra* note 107, at 14.

c. *Country Where Taxpayer Resides*

The taxpayer's country of residence provides public benefits that relate to the taxpayer's earning and enjoyment of income. Specifically, the residence country contributes to the ability of a taxpayer to acquire and protect the wealth arising from income by providing a legal system that governs rights and obligations.<sup>249</sup> These public benefits include the creation of a court system and the regulation of financial markets and commercial activity. Moreover, through military protection and agencies that are responsible for relationships with other nations, a country is providing services that protect its residents' financial interests in other countries.<sup>250</sup> For income that is consumed by individuals, the residence country provides important governmental benefits to the individual that relate to consumption;<sup>251</sup> one would be unable to spend and consume income within a given country in the absence of the governmental services that support physical, legal, and economic infrastructure as well as public safety.<sup>252</sup>

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249. See Mason, *supra* note 84, at 1554 (noting property protection among the governmental benefits provided by a country to its residents); Reuven S. Avi-Yonah, *The Case Against Taxing Citizens* 7 (Univ. of Michigan Law School Pub. Law & Legal Theory Working Paper Series, Paper No. 190, 2010), <http://ssrn.com/abstract=1578272> [hereinafter Avi-Yonah, *Case Against*] (pointing out that U.S. residents benefit from the rule of law and government protection, among other government benefits); McLure, *supra* note 153, at 149 (finding it more appropriate that the residence country rather than the source country should have the right to tax the normal return to capital because "the residence country creates the economic climate favorable to the creation of portfolio capital by practicing public fiscal virtue and by nourishing private thrift" (quoting from GARY CLYDE HUFBAUER, U.S. TAXATION OF INTERNATIONAL INCOME: BLUEPRINT FOR REFORM 67 (1992))); cf. Zelinsky, *supra* note 146, at 1316 (concluding that the extensive civil and social rights of U.S. residents may justify taxing their worldwide incomes under a benefit theory).

250. See Roin, *supra* note 184, at 588–89 (pointing out that countries may assist their residents in the event of military or political instability as well as trade disputes); Michael S. Kirsch, *Taxing Citizens in a Global Economy*, 82 N.Y.U. L. REV. 443, 472–73 (2007) [hereinafter Kirsch, *Taxing Citizens*]. More specifically, the United States has entered into dozens of Bilateral Investment Treaties, which provide U.S. citizens and corporations basic protection for their business operations and investments in other countries. *Id.* at 473.

251. See Harris, *supra* note 137, at 447; cf. Graetz & Grinberg, *supra* note 76, at 569 (noting that because countries fund government services that provide for the well-being of their residents, countries seem to deserve priority in taxing the foreign portfolio income of their residents).

252. See Jefferson VanderWolk, *The Deferral Debate and the Benefits Theory*, 20 TAX NOTES INT'L 1469, 1470 (2000) [hereinafter VanderWolk, *Benefits Theory*] (stating that the residence country provides consumption-related services that support individuals' ability to enjoy income); cf. Avi-Yonah, *Case Against*,

To an extent, current law appears to recognize the benefits provided by the residence country in assigning jurisdiction to tax. For example, although the U.S. rules generally source interest income according to the residence of the borrower,<sup>253</sup> most interest paid by U.S. persons to nonresidents is exempt from U.S. tax under the portfolio interest exemption.<sup>254</sup> While the stated reason for this exemption is to allow U.S. borrowers the opportunity to participate in the Eurobond market,<sup>255</sup> the notion that the resident country has a greater right to tax such interest may also play a role.<sup>256</sup> More generally, treaties usually assign the right to tax interest and royalties to the residence country<sup>257</sup> and significantly reduce the rate of source taxation on dividends.<sup>258</sup> Again, although the prevention of excessive source taxation is an important reason for these treaty provisions,<sup>259</sup> they also seem to reflect a determination that the residence country has the greater taxing rights over these types of income,<sup>260</sup> or that at least tax jurisdiction should be shared between the residence and source countries.

## 2. *Unifying the Activities, Destination, and Residence Approaches for Sourcing Income*

### a. *The Benefits Principle and the Propriety of Split Sourcing*

As discussed above, several countries may be providing governmental benefits to a taxpayer that relate to the taxpayer's income, with these countries grouped into three categories — location of activities;

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*supra* note 249, at 7 (pointing out the U.S. residents benefit from the “many opportunities of a free market economy”).

253. *See* I.R.C. § 861(a)(1).

254. *See* I.R.C. §§ 871(h), 881(c). Many developed countries likewise exempt interest paid to nonresidents. *See* ALI PROJECT II, *supra* note 21, at 194.

255. *See supra* notes 70–72 and accompanying text.

256. *See* ALI PROJECT II, *supra* note 21 at 194 (providing as a possible explanation for the portfolio interest exemption that the source country's claim to tax interest received by a nonresident may be considered to be weak); Graetz & Grinberg, *supra* note 76, at 569 (stating that the source country's claim to tax portfolio income is more attenuated than its claim to tax business income and that the claims of the residence country seem to deserve priority in the inter-nation allocation of tax jurisdiction over portfolio income; pointing out that primary allocation of taxing rights over portfolio income reflects this priority).

257. *See supra* notes 22, 28 and accompanying text.

258. *See supra* note 23 and accompanying text.

259. *See supra* notes 74–75 and accompanying text.

260. *See supra* notes 76–78.

destination of property, capital, or services; and country of residence. In many situations, more than one country in different categories may provide benefits. For example, a taxpayer who resides in one country may receive dividends from a corporation that is incorporated and does business in another country. In this situation, there are governmental benefits relating to the income provided by both the residence country (where the taxpayer resides) and the destination country (where the corporation is incorporated and does business, which is the destination of the taxpayer's invested capital). In fact, for a given item of income, countries in all three categories may provide benefits. For example, a taxpayer who resides in one country may develop an intangible in another country and license the intangible for use in a third country. Here, the taxpayer is receiving public benefits from the residence country, the activities country (where the intangible is developed), and the destination country (where the intangible is being used). Current law addresses such situations by sourcing all of the income to one of the countries involved.<sup>261</sup> Thus, in the first situation, all of the dividends are sourced to the country of destination despite the public benefits that are also provided in the residence country.<sup>262</sup> And in the second situation, all of the royalties are sourced to the destination country even though all three countries are benefiting the taxpayer.<sup>263</sup>

The current approach apparently is to choose the country to which the income primarily relates.<sup>264</sup> However, this can sometime lead to arbitrary determinations;<sup>265</sup> it is not always clear which of the countries is the greatest contributor to the income in question. More fundamentally, the current "single source" approach is inappropriate given that often more than one country is providing significant public benefits. Furthermore, an approach that seeks to determine the primary country that is providing public benefits can lead to disagreements among nations,<sup>266</sup> and thus does not appear suitable for multilateral adoption.

Instead, a unified approach is called for, one that recognizes those countries that provide significant public benefits that relate to the income. Accordingly, this Article proposes that multilateral source rules be devised pursuant to a standard that evaluates income for sourcing on the basis of three factors: the destination of the services, property, or capital giving rise

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261. See, e.g., *supra* notes 19–20, 25–27 and accompanying text.

262. See *supra* notes 19–20 and accompanying text.

263. See *supra* notes 25–27 and accompanying text.

264. See Lokken, *Intellectual Property*, *supra* note 57, at 242–43; ALI PROJECT I, *supra* note 14, at 18 (stating that the current source rules used in the United States and elsewhere are result of a process that seems "to require a balancing of the strength of conflicting claims and considerations as they apply to particular types of income").

265. See Mason, *supra* note 84, at 1591.

266. See *supra* notes 110–16 and accompanying text.

to income; the location(s) of the activities giving rise to income; and the residence of the person receiving income.<sup>267</sup> Each of these countries has the potential for contributing significantly to the earning and enjoyment of income, as demonstrated above<sup>268</sup> and as reflected in the current source rules.<sup>269</sup> Under this standard, a given item of income may have its source

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267. Cf. Azam, *supra* note 132, at 30–31 (proposing that source rules for taxing electronic commerce be developed by taking into account the locations of producers, consumers, and other physical facilities and components that contribute to e-commerce income, so that the tax pie can be divided fairly among countries). These factors, and the bases for them, are conceptually consistent with the idea of economic allegiance for determining the tax jurisdiction of countries that was developed by four prominent economists in their seminal report for the League of Nations. See Economic and Financial Commission, League of Nations, *Report on Double Taxation Submitted to the Financial Committee by Professors Bruins, Einaudi, Seligman, and Sir Josiah Stamp*, League of Nations Doc. E.F.S.73F.19 (1923). In determining the meaning of economic allegiance, the report identified four fundamental considerations: (i) the acquisition of wealth, (ii) the location of wealth, (iii) the enforceability of the rights to wealth, and (iv) the consumption of wealth. *Id.* at 22–23. Corresponding to these considerations are four points that are significant in determining the appropriate place of taxation: (i) the place of origin of wealth, (ii) the situs of wealth, (iii) the place of enforcement of the rights to wealth, and (iv) residence or domicile. *Id.* at 23. The report concludes that of the four, the place of wealth origin and residence or domicile of the taxpayer are the most important, with the other two factors mostly significant in reinforcing the tax claims of the country of origin or domicile. *Id.* at 25. In examining the origin of wealth with respect to the human relations that help create wealth, the report discusses the places where activities such as management occur as well as “[t]he selling end, that is, the place where agents for selling ply their calling and where the actual markets are to be found.” *Id.* at 24. And in applying the economic allegiance criteria to real estate mortgages, the report views the place of wealth origin as where the land is located, apparently embracing an approach that determines origin in this context based on the destination of the loaned capital. See *id.* at 34–35; but cf. *id.* at 36 (in evaluating the origin of income on corporate shares, the report favors the place where the owners of the corporation, *i.e.*, the shareholders, reside, as opposed to the place where the corporation earns the dividends, especially because determining the location of the underlying corporate earnings would be complicated where the corporation has production, sales, or a chief office in more than one country). Thus, similar to the factors identified in this Article, the League of Nations report focuses on where the taxpayer resides and where wealth is produced, with the latter apparently taking into account both the activities giving rise to income along with the destination of the products or capital in some cases.

268. See *supra* notes 234–35, 238, 240, 242, 244–45, 249–52 and accompanying text.

269. See *supra* notes 236–37, 239, 241, 243, 253–58 and accompanying text; cf. Avi-Yonah, *Globalization*, *supra* note 231, at 1586–87 (pointing out that three types of jurisdictions may, under current rules, impose a tax on cross-border sales of goods or provision of services: both the supply and demand jurisdictions

divided among multiple locations.<sup>270</sup> Thus, in the second example above,<sup>271</sup> a portion of the royalty income would be sourced to the residence country, the activities country, and the destination country. Subsection 3, below, discusses the specifics of assigning income portions.<sup>272</sup>

*b. Defending the Residence Country Source Portion*

For the most part, commentators appear to view a split-sourcing approach as appropriate from the standpoint of the benefits principle.<sup>273</sup> The

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may impose a source tax, and the residence jurisdiction may impose residual tax that is not taxed by the supply or demand jurisdictions).

270. Cf. Kevin A. Bell, *Indian Official Says Source Country Should Have Greater Taxing Rights*, INT'L TAX MON., Feb. 26, 2008 (Indian official quoted as stating that the source country and residence country should each have the right to tax one half of certain income that originates in India).

271. See *supra* text accompanying note 261.

272. As voiced by a leading commentator, a concern with the functioning of source rules is the potential for taxpayers to erode completely their effect in a given jurisdiction by making deductible payments to related parties located in a second, low tax jurisdiction. See Edward D. Kleinbard, *Stateless Income* 62–63 (USC Legal Studies Research Paper No. 11-6, 2011), <http://ssrn.com/abstract=1791769> (“Even if a multinational enterprise’s income is sourced in the first instance by every country according to some economically rational set of agreed-upon principles, stateless income tax planning simply extracts the income from the source country (for example, through deductible interest, royalty, or fee payments) and deposits it in a tax-friendlier locale.”). This concern is based on the assumption that the deductible payments in the first jurisdiction are not subject to a source tax in that jurisdiction. See *id.* at 15. Under the proposed sourcing standard, this should not be the case if, as the commentator assumes (see *id.* at 62–63), the first jurisdiction is the destination of services or an intangible and is not a tax haven — in these circumstances, a portion of the deductible payments would be sourced and taxed in the first jurisdiction.

273. See, e.g., ALI PROJECT I, *supra* note 14, at 35–36, 48 (stating that it seems anomalous to assign all of the rental income from leasing tangible property produced by the taxpayer to the country of use; noting that conceptually royalty payments received on the license of intangible property developed by the taxpayer represent income generated by both the creation and exploitation of the intangible); Lokken, *Intellectual Property*, *supra* note 57, at 242 (acknowledging that with regard to royalty income received from the license of intangible property developed by the taxpayer, both the country that was the situs of development activities and the country where the intangible is used provide important services and protections); Christians, Donaldson & Postlewaite, *supra* note 80, at 20–21 (stating that a highly analytical approach for determining the source of service income might attribute the income to one or more jurisdictions, each of the contacts with which provides an economically defensible basis for determining source).

major concerns with such an approach are administration<sup>274</sup> and coordination among countries,<sup>275</sup> which are addressed in the next subsection. However, some leading commentators would probably take issue with sourcing a portion of income to the country of residence. With regard to U.S. source taxation, they assert that where a nonresident is doing business in the United States (or possibly accessing the U.S. market), the public benefits provided by the United States to the nonresident are quite similar to the public benefits provided to residents, thus justifying a source tax that is equivalent to that imposed on U.S. residents.<sup>276</sup> These commentators also are concerned that U.S. residents would perceive a lower tax for nonresidents as inequitable, and thus damage the legitimacy and efficacy of the residence tax.<sup>277</sup> The commentators specifically disagree with other analysts,<sup>278</sup> who argue that nonresidents should pay a lower tax than residents on income earned in a particular country because the nonresidents are receiving fewer public benefits from that country.<sup>279</sup>

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274. See, e.g., ALI PROJECT I, *supra* note 14, at 36, 48 (pointing out administrative difficulties of splitting the source of rental income received from leasing tangible property produced by the taxpayer; pointing out administrative difficulties of splitting the source of royalty income received from licensing intangible property developed by the taxpayer); Lokken, *Intellectual Property*, *supra* note 57, at 242–43 (pointing out administrative difficulties of splitting the source of royalty income received from licensing intangible property developed by the taxpayer); cf. Christians, Donaldson & Postlewaite, *supra* note 80, at 21 (stating that the U.S. source rule for service income, which looks to the place where services are performed, is probably based primarily on administrative considerations).

275. See, e.g., ALI PROJECT I, *supra* note 14, at 37, 48 (stating that no case has been found in which a country divides the source of rental income between the place where the leased property was produced and the place where it is being used; noting that few if any countries divide the source of royalty income between the place where the licensed property was developed and the place where it is being used).

276. See Shay, Fleming & Peroni, *Source Rules*, *supra* note 1, at 90–91; cf. Lokken, *Intellectual Property*, *supra* note 57, at 239 (asserting that consumer benefits received by individuals are not related to the issue of source of income).

277. See Shay, Fleming & Peroni, *Source Rules*, *supra* note 1, at 110–11.

278. See *id.* at 90–91.

279. See Harris, *supra* note 137, at 457 (the rate of tax on nonresidents with domestic income should be less than that on residents with domestic income, “because nonresidents deriving domestic income receive less government services than residents deriving such income, *i.e.*, they are not in receipt of residence or consumption services from the domestic government”); VanderWolk, *Benefits Theory*, *supra* note 252, at 1470 (arguing that the taxation of foreign–source business income should be divided more or less equally between the residence country and the source country because of the governmental services provided by each country); Jefferson VanderWolk, *Direct Taxation in the Internet Age: A Fundamental Approach*, BULL. FOR INT’L FISCAL DOCUMENTATION, Apr. 2000, at 173, 179

This criticism is not warranted. First and foremost, assigning a portion of income to the residence country is in accord with the benefits principle.<sup>280</sup> Because a resident benefits from home country government activities with respect to income that is either accumulated or consumed, the residence country should have a primary right to tax at least a portion of income that is derived from activities or market access that occurs outside of that country.<sup>281</sup> This in turn should reduce the income over which the countries of activities and destination should have a right to tax.<sup>282</sup> To support this proposition, consider the case of an individual who resides in

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(proposing an approach under which the tax rate on the local-source income of nonresidents is lower than the rate on residents' income, because nonresidents receive less governmental benefits than residents – nonresidents “receive only production services, not consumption services”); *cf.* Roin, *supra* note 184, at 591 (stating that “[a] case may be made for imposing a lower tax on the U.S. income of foreign corporations than on the U.S. income of domestic corporations,” because foreign corporations are receiving less benefits from the United States as compared to domestic corporations); Avi-Yonah, *Case Against*, *supra* note 249, at 7 (in arguing against the United States taxing nonresident citizens on their worldwide income, pointing out that nonresident citizens do not receive certain significant benefits that are received by U.S. residents or only receive them in a substantially weaker form).

280. Several commentators agree with this proposition. *See supra* note 279.

281. *See* VanderWolk, *Benefits Theory*, *supra* note 252, at 1470 (arguing that the taxation of foreign-source business income should be divided more or less equally between the residence country and the source country because of the governmental services provided by each country); Harris, *supra* note 137, at 462–63 (proposing that residents deriving foreign income should be taxed by the residence country on their worldwide taxable income at the full residence income tax rate, “but should receive a tax credit with respect to their foreign income at the source income tax rate,” with the source tax rate being lower than the residence tax rate; this will result in residents with foreign income contributing to the cost of the “government services they receive, *i.e.*, consumption services”); Roin, *supra* note 184 at 588–89 (in arguing for a system where the United States exempts foreign income from taxation, contending that the government benefits provided by the United States to U.S. corporations with respect to foreign income “may be substantial enough to justify some home country tax” on such income); *cf.* McLure, *supra* note 153, at 149 (finding it more appropriate that the residence country rather than the source country should have the right to tax the normal return to capital because “the residence country creates the economic climate favorable to the creation of portfolio capital by practicing public fiscal virtue and by nourishing private thrift” (quoting from GARY CLYDE HUFBAUER, *U.S. TAXATION OF INTERNATIONAL INCOME: BLUEPRINT FOR REFORM* 67 (1992)).

282. *See* Roin, *supra* note 184, at 591 (“Exactly the same factors that justify the imposition of an add-on tax imposed with respect to the foreign income of a U.S. corporation, then, justify a corresponding downward adjustment in the rate of corporate tax payable on the domestic income of foreign corporations.”).

Country A but who derives all of her income from Country B, which has a tax rate that exceeds the Country A tax rate, thus precluding any residual tax by Country A even if it employed a foreign tax credit system as opposed to an exemption system. The individual consumes all of her income in Country A, and uses the banking and financial system of Country A to protect the wealth that accumulates from the income. Furthermore, the government activities of Country A, through its military and state department, protect her property rights in Country B.<sup>283</sup> If the individual's income were sourced only on the basis of activities and destination, she would pay no tax to Country A, despite the public benefits that she receives from Country A. To prevent this, at least a portion of the taxpayer's income should be assigned to Country A for primary taxation purposes in order for the taxpayer to shoulder some of the burden of Country A governmental costs from which the taxpayer clearly benefits.

As far as the perceived inequity of a country taxing nonresidents less heavily than residents (which would occur where a portion of the income is sourced to the residence country), residents may well not feel that they are being unfairly treated given that nonresidents are receiving fewer benefits — in particular, a lack of public benefits relating to personal consumption. Indeed, an argument can be made that if nonresidents are subject to the same taxes as residents despite receiving fewer public benefits from the host country, the nonresidents may be the ones who feel that they are being treated unfairly. This could result in less compliance by nonresidents as well as steps taken to reduce their exposure to source taxation — for example, by avoiding a presence in the host country and instead carrying out host country activities remotely.

The difference in benefits provided to residents and nonresidents may also mitigate or eliminate any concerns that nonresidents would have an advantage in competing with residents in the particular country. A lower source tax on nonresidents would only present this concern where the difference in tax burden is not being made up by tax liability in the residence country on the portion of the income sourced to it. With substantially harmonized source rules (the end-product of this Article's endeavor), there would likely be a lack of a significant residence tax only where the residence country is not providing important benefits to its individuals and corporations, such as stable legal protections.<sup>284</sup> In this regard, investors in a tax haven corporation would likely have a higher degree of legal risk than

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283. See Roin, *supra* note 184, at 588–89; Kirsch, *Taxing Citizens*, *supra* note 250, at 473.

284. Cf. Roin, *supra* note 184, at 589 (differences in the tax rates imposed by countries often reflect differences in the level of governmental benefits provided)

investors in a corporation from a developed country.<sup>285</sup> Given this tradeoff, nonresidents may well not have a competitive advantage over residents even if the nonresidents faced lower overall tax liability.<sup>286</sup> Nevertheless, host countries could always remove any perceived advantage by subjecting the residence country source portion of income to a form of residual source taxation — that is, a host country could impose a tax on the entire portion of a nonresident's income that is derived from the host country, subject to a credit for any residence country taxes that are imposed on the portion of the income that is sourced to the residence country.<sup>287</sup>

An additional reason for assigning a portion of income to the residence country is to have a reasonable allocation of tax jurisdiction that can be agreed to by nations on a multilateral basis. Under the destination component of the proposed standard, where a taxpayer earns income by accessing a country's market, a portion of the income should be assigned to that country even without the taxpayer's actual presence in the country, which is not the case under current law.<sup>288</sup> Similarly, the proposed standard will assign taxing rights over a portion of interest and royalty income to the destination country, thereby altering the typical rights of residence countries to tax such income in its entirety.<sup>289</sup> These features of the standard thus expand the reach of source taxation. Allowing residence countries a primary right to tax a portion of income is an appropriate and fair counterbalance to these features, and a measure that is more likely to bring about international accord on a sourcing standard.<sup>290</sup>

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285. *Cf.* Kleinbard, *Lessons*, *supra* note 84, at 77 n.172 (noting that despite the clear tax advantages of using a foreign corporation, it is difficult to find examples of successful new public firms that have been organized by U.S. entrepreneurs as foreign firms).

286. *Cf.* Roin, *supra* note 184, at 588–91 (contending that the proposed structure, which generally exempts U.S. corporations' foreign income but considers the imposition of an add-on tax on such, and considers taxing foreign corporations on U.S. income at a lower rate than that applied to the U.S. income of U.S. corporations, adheres rather closely to capital export neutrality, with neutrality "expanded to include governmental benefits").

287. This would be similar to the tax imposed under section 877, under which a nonresident alien who is treated as having expatriated to avoid U.S. tax is subject to U.S. tax on U.S. source income, as expanded under the provision, but with a credit for foreign taxes on income that is taxable solely as a result of section 877. *See* I.R.C. § 877(a), (b), (d).

288. *See supra* notes 36–38 and accompanying text.

289. *See supra* notes 21–22, 28 and accompanying text.

290. Notwithstanding the conceptual basis for residence-based sourcing, there is a concern over determining the residence of corporations, which of course is necessary in deciding where to source the residence-based portion of income earned by corporations. *Cf.* Andrus, *supra* note 42, at 848 (pointing out that residence-based source rules will place tremendous pressure on the residence definition). Under U.S.

c. *Less Stress on Characterization*

In addition to doing a better job of effectuating the benefits principle, the proposed standard would also reduce or possibly eliminate the current stress that is placed on characterizing income items for purposes of applying source rules. As mentioned previously, under the current source rules, a great deal turns on how income is characterized.<sup>291</sup> This is because the current single source rules result in very different results depending on the type of income involved. For example, under the U.S. rules, royalties received on a license of a patent are sourced where the patent derives its legal protection,<sup>292</sup> whereas gain on the sale of a patent for a fixed price is sourced where the

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law, corporate residency is based on the country of incorporation. See I.R.C. § 7701(a)(4), (5). As a consequence, a publicly traded corporation can avoid being subject to U.S. tax on its worldwide income, as well as being subject to subpart F on foreign income, simply by being incorporated outside the United States. See Shay et al., *Task Force*, *supra* note 26, at 746–47. This concern has prompted some commentators to advocate tests for determining corporate residency that focus on what are arguably more meaningful factors than the place of incorporation. See *id.* at 749–55 (evaluating alternative tests and concluding that the place of incorporation should be retained); Kleinbard, *Lessons*, *supra* note 84, at 76 (stating that the current U.S. corporate residence test can be modernized to look to a corporation’s “mind and management,” a U.K. concept). Recently, bills have been proposed in Congress that would enact a new section 7701(p), which would treat any large or publicly-traded foreign-organized corporation as a domestic corporation for U.S. tax purposes if the management and control of the corporation occurs primarily in the United States. See International Tax Competitiveness Act of 2011, H.R. 62, 112th Cong.; International Tax Competitiveness Act of 2010, H.R. 5328, 111th Cong.; see also Stop Tax Haven Abuse Act, H.R. 1265, 111th Cong. (2009); Stop Tax Haven Abuse Act, S. 506, 111th Cong. (2009); Jim Brown et al., New York State Bar Association, Report on the Management and Control Provision of the “International Tax Competitiveness Act of 2011” (2011) (providing comments on this legislative proposal). While determining corporate residency is important in crafting harmonized source rules that use residence-based sourcing, this issue will need to be left for a future endeavor. For now it may be useful to point out that one basis for sourcing a portion of income to the residence country, the legal protections provided by that country, may support a corporate residence test that looks to the country of incorporation; nevertheless, the fact that a country also provides public benefits, such as infrastructure, that make possible the domestic management activities of a company may also support a residence test that looks to the place of management and control. If it is appropriate to focus on factors beyond the place of incorporation, in addition to the currently proposed legislation, several alternative tests have been suggested for determining corporate residency for purposes of residence taxation. See Shay et al., *Task Force*, *supra* note 26, at 749–55.

291. See *supra* notes 102–06 and accompanying text.

292. See *supra* notes 25–26 and accompanying text.

seller resides.<sup>293</sup> Characterization is particularly problematic in the case of transactions involving intangibles and electronic commerce, where the income from a given transaction may take the form of royalties, compensation, or property gains based on the specific facts and circumstances.<sup>294</sup>

As a consequence, the current approach often leads to a great deal of uncertainty, as well as the potential for double taxation or non-taxation, because countries may be characterizing an item differently (even if they used similar source rules).<sup>295</sup> More fundamentally, the current rules are flawed in that they produce different source results for transactions that are economically similar.<sup>296</sup> This in turn creates planning opportunities for taxpayers, with the attendant concerns of manipulation, compliance, and enforcement.<sup>297</sup> To restate an illustration provided earlier,<sup>298</sup> where a U.S. resident develops an invention in the United States, obtains a foreign patent on the invention, and then sells the foreign patent for a lump sum, all of the gain will be U.S. source;<sup>299</sup> however, if instead of selling the patent the taxpayer licenses the patent in exchange for a lump sum royalty for a period that is slightly less than the patent's remaining life, all of the income would be foreign source.<sup>300</sup> Despite the similarity in the substance of these two alternatives, the source results are quite different.

Under the proposed standard, there would be similar source results regardless of how a transaction is characterized. Because the sourcing standard calls for rules that would divide the source of income among the countries of activities, destination, and residence, economically similar transactions would have the same or similar source results. Specifically, in the case of an intangible developed by the taxpayer, the standard would support a rule that allocates the source of royalty income among the country

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293. See *supra* notes 43–44 and accompanying text.

294. See *supra* note 102.

295. See *supra* note 117 and accompanying text.

296. See Harry Grubert, *Tax Credits, Source Rules, Trade, and Electronic Commerce: Behavioral Margins and the Design of International Tax Systems*, 58 TAX L. REV. 149, 188 (2005) (pointing out that “the current distinction in the U.S. source rules between a sale of a good, a royalty, and a service is highly artificial and serves no policy objective;” stating that the current Treasury regulations for sourcing income from computer software exemplifies this confusion given that different types of transactions involving software are highly substitutable from the developer’s point of view).

297. See Noren, *supra* note 102, at 345 (pointing out that distinguishing e-commerce income among existing source categories appears to be highly prone to manipulation).

298. See *supra* notes 105–06 and accompanying text.

299. See *supra* note 105.

300. See *supra* note 106.

where the intangible was developed, the country where the intangible is being used, and country where the taxpayer resides.<sup>301</sup> The same rule should be appropriate for gain from the sale of an intangible developed by the taxpayer.<sup>302</sup> Consequently, the different source results in the example above would no longer hold true.

Because the sourcing standard recognizes the public benefits of the different countries involved, and the location of these benefits relates to the economic substance of a transaction, rules developed pursuant to the standard should produce similar sourcing results for transactions with similar economic substance. This would reduce the uncertainty and potential for taxpayer manipulation that plague current law. It would also avoid the need for harmonized characterization rules for nations, which would be necessary if multilateral source rules continued to use a single source approach with different rules based on the type of income involved. Although there are single source rule options for reducing uncertainty and manipulation, such as residence-based<sup>303</sup> or destination-based sourcing<sup>304</sup> for all service and intangible income, these approaches would be distortive in light of the benefits principle and may well not be acceptable internationally.<sup>305</sup>

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301. See *infra* notes 370–73 and accompanying text.

302. See *infra* notes 374–76 and accompanying text.

303. See Andrus, *supra* note 42, at 856.

304. See ALI PROJECT I, *supra* note 14, at 49–50, 57; Noren, *supra* note 102, at 345 (suggesting that source rules for e-commerce income focus on the location of the consumer in order to avoid the difficult classification issues that arise under current law).

305. See Andrus, *supra* note 42 at 856. An additional benefit of the proposed sourcing standard is that there would generally be less opportunity under foreign tax credit limitations for cross-crediting (see *supra* note 62 and accompanying text), given that there would be a greater likelihood that income treated as foreign source would be subject to a significant tax by a foreign country. For example, under current U.S. law, portfolio income is typically sourced based on the destination of capital or property, yet the destination country typically imposes little or no tax on most types of such income. See *supra* notes 17–28 and accompanying text. Under the proposed sourcing standard, only a portion of portfolio income would be sourced to the country of destination (see *supra* notes 267–272 and accompanying text), and the destination country would generally be imposing a tax at a significant rate on that portion (see *supra* note 139–143). Consequently, the proposed sourcing standard should reduce the pressure placed on the strictness of foreign tax credit limitations. See ALI PROJECT I, *supra* note 14, at 348 (pointing out the inverse relationship between the foreign tax credit basket limitations and the restrictiveness of the source rules for U.S. persons); Shay, Fleming & Peroni, *Source Rules*, *supra* note 1, at 152–53 (same).

### 3. Addressing Administrative and Coordination Concerns

#### a. An Allocation Scheme that Avoids Administrative Difficulties

Commentators who agree that the current source rules are arbitrary because they typically choose the primary country that provides related public benefits, while ignoring other countries that are also providing benefits, view the current approach as necessary.<sup>306</sup> That is, while in a given situation there may be connections to several different countries, an approach that attempted to attribute income to each of the countries involved would be overly complex and administratively difficult.<sup>307</sup>

While taking into account all benefit-providing nations would be unworkable, the proposed standard eschews such an approach in favor of one that limits the source inquiry to the countries that are likely to provide significant public benefits that relate to the income in question. Thus, certain less significant connections, such as the residence of the payer or the place where payment is made, are ignored because it is administratively impossible to allocate income to every country with some connection to the transaction.

In applying the standard to devise rules, certain additional lines should be drawn to promote administrability. For example, service income should be sourced without regard to where the taxpayer was educated or developed her skills. Although the development of human capital is related to earning compensation income and could fall within the activity component of the proposed sourcing standard,<sup>308</sup> taking this into account appears too difficult administratively; moreover, human capital development would likely occur at the place where services are performed,<sup>309</sup> and under the standard a portion of the income will be sourced there in any event. In the same vein, source rules devised pursuant to the standard should use reasonably certain indicia for the place of activities or destination. For example, in determining the destination of goods or services, the rules should use well-developed factors such as the “use, consumption, or disposition” concept that is currently used under U.S. law.<sup>310</sup> Similarly, it would be

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306. See, e.g., Christians, Donaldson & Postlewaite, *supra* note 80, at 20–21.

307. See *id.* at 20.

308. Cf. Shay, Fleming & Peroni, *Source Rules*, *supra* note 1, at 140 (arguing that the country where a service provider’s extensive human capital was developed would seem to have a claim to tax a portion of the service income).

309. See Graetz & Grinberg, *supra* note 76, at 569.

310. See Reg., § 1.864-6(b)(3)(ii). Nevertheless, with the potential for split sourcing of income between activities and destination countries, there will be the need for more factual determinations than under current law’s single source approaches.

advisable for the location of taxpayer activities to be limited to those jurisdictions where taxpayers engage in *significant* activities involving manufacturing, sales, development, or services that relate to the income in question.

The most important administrative issue with the proposed sourcing standard is determining the portions of income that should be assigned to the different components. That is, once it is decided that an item of income should be divided among the standard's components, what method should be used to make the allocation? For many situations, there would not be a precise basis for making allocations. For example, it would be nearly impossible to value the public benefits provided by the residence country in order to determine an allocation for the residence country component, assuming that the allocation of income based on the relative amount of public benefits provided by jurisdictions is considered appropriate.<sup>311</sup> Likewise, where income is allocated to the destination country because a taxpayer has accessed that country's market by selling goods or services into the country, the value of the public benefits provided by the destination country appears to be indeterminable. In some cases, arm's length pricing principles may provide a basis for making allocations, but these principles would only be helpful in assigning income to business-related activities and transactions. Thus, the arm's length method would not be able to determine the portion of portfolio income that should be allocated to a residence country, or the appropriate allocation of income between the country of sales activities and the country of destination. Yet, some allocation is appropriate in light of the public benefits provided at the different locations.

To address these difficulties, allocations among the components of the sourcing standard generally should be made using fixed percentages that are mutually agreed upon by countries.<sup>312</sup> An inexact allocation using fixed percentages is the only practical approach for split sourcing where it is not possible to determine with any degree of precision the relative value of

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311. In this regard, several leading commentators have expressed their opposition to an approach that would partially exempt international income from the tax bases of the source and residence countries based on the view that international income receives fewer governmental benefits than income earned within a taxing country by its residents. See Fleming, Peroni & Shay, *Fairness*, *supra* note 165, at 334–37. The commentators object to this approach in part because the approximate cost of the government benefits provided by the countries involved is not capable of being measured. See *id.* at 336–37.

312. The determination of these percentages should generally be made based on a rough evaluation of the amount of public benefits provided by the residence, activities, and destination countries. However, as mentioned previously, it may be appropriate also to take into account equity considerations underlying ability-to-pay taxation in determining the portion of the income that is sourced to the country of residence. See *supra* notes 183–85 and accompanying text.

government benefits provided by countries. And such an approach is superior to no allocation at all because it at least recognizes that more than one country is providing significant government benefits that relate to the income.<sup>313</sup> As an illustration of this approach, countries may decide that service income should be allocated by assigning one third of the income to each of the countries where the services are performed, where the services are used or consumed, and where the taxpayer resides.<sup>314</sup>

The use of fixed percentage allocations to source income has support under current law. For income that is attributable to transportation that either begins or ends in the United States, the current U.S. rules treat 50 percent of the gross income as U.S. source and 50 percent as foreign source.<sup>315</sup> The U.S. rules also use a 50–50 method to source international communications income that is earned by U.S. persons.<sup>316</sup> Similarly, income from the manufacture and sale of inventory is generally sourced by allocating 50 percent of income to the place of manufacturing and 50 percent of the income to the place of sales.<sup>317</sup> Furthermore, the apportionment formulas used by U.S. states provide analogous support for using fixed percentages in sourcing income. These formulas typically apportion income among states by using fixed percentage factors — for example, an equally weighted three-factor formula that takes into account the location of sales, payroll costs, and assets.<sup>318</sup> Recently, some commentators have proposed using similar formula apportionment schemes in lieu of transfer pricing to allocate income among affiliated corporations.<sup>319</sup> These measures reflect a judgment that where more precise allocations are unavailable or too difficult, a reasonable allocation of tax jurisdiction based on fixed percentages is superior to no allocation whatsoever.

As alluded to above, it would be appropriate to use arm's length pricing principles to allocate income within the activities component. For example, in lieu of the 50–50 method generally used under U.S. law to

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313. Moreover, an inexact method of allocating income should not be viewed as inappropriate given that the benefits principle's equity basis for sourcing is somewhat imprecise in light of the value judgments involved. *See supra* notes 155–157, 182 and accompanying text.

314. *Cf.* Bell, *supra* note 270 (Indian official quoted as stating that giving the residence and source countries the rights to tax one half of certain income that originates in India “would be an amicable resolution of the problem”).

315. *See* I.R.C. § 863(c).

316. *See* I.R.C. § 863(e).

317. *See* Reg. § 1.863-3.

318. *See* Charles E. McClure, Jr., *Legislative, Judicial, Soft Law, and Cooperative Approaches to Harmonizing Corporate Income Taxes in the US and the EU*, 14 COLUM. J. EUR. L. 377, 420–21 (2008) (describing the formulary methods used by U.S. states to apportion business income).

319. *See, e.g.*, Avi-Yonah, Clausing & Durst, *supra* note 136.

allocate income between manufacturing activities and sales activities, it would be advisable to base such allocations on the arm's length method.<sup>320</sup> This would allow for a determination that takes into account the economic income attributable to these activities, which should serve as a reasonable proxy for the relative amount of government benefits provided at these locations. The use of arm's length principles to allocate income among a taxpayer's activities would also promote the neutral treatment of activities conducted through branches and subsidiaries, given the use of the arm's length method to allocate income where activities are conducted through affiliated corporations.<sup>321</sup> For the same reasons, it would be appropriate to use arm's length principles to allocate income within the activities component in other situations, such as in the case of global dealing operations involving financial products.<sup>322</sup> The use of arm's length principles in these and other similar situations is generally consistent with the functional separate entity method that is authorized by the OECD model treaty as well as by some recent U.S. treaties.<sup>323</sup>

In theory, arm's length principles can also be used in certain situations to allocate income between the activities component and the destination component of the sourcing standard. For example, where a bank incorporated in Country A makes a loan to a resident of Country B, with all of the loan activities done at a branch located in Country C, it may be possible to divide the interest income received by the bank between the activities and destination components by determining an arm's length charge for the banking services performed by the Country C branch. This may provide an economically justifiable way of determining the portion of the interest that represents compensation for the banking services and the portion that represents compensation for the use of money. (A portion would still need to be assigned to Country A, the residence country). However, a

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320. See ALI PROJECT I, *supra* note 14, at 29–33 (recommending that the source of income from the production and sale of tangible personal property be determined by apportioning the income between the countries of production activities and sales activities using arm's length principles).

321. See Fred B. Brown, *Federal Income Taxation of U.S. Branches of Foreign Corporations: Separate Entity or Separate Rules?*, 49 TAX L. REV. 133, 193–95 (1993); ALI PROJECT I, *supra* note 14, at 33. Nevertheless, the results under the sourcing standard for subsidiary versus branch operations will differ where parent and subsidiary corporations have different residences, in light of the residence component of the standard.

322. Proposed Treasury regulations are in accord with this approach. See Prop. Reg. § 1.482-8.

323. See, e.g., OECD Model, *supra* note 15, at art. 7; U.S. Model, *supra* note 22, at art. 7. Unlike the treaty separate entity method, however, the proposed standard would source a portion of the income based on the residence of the taxpayer.

problem with using arm's length principles to make this allocation is that since the interest would be received over time, it would be necessary to apportion each payment of interest between the banking services element and use of money element, which would require the use of present value concepts to achieve a degree of accuracy. Moreover, given the uncertainty in determining an arm's length charge for the banking services at the Country C branch, using this method would severely complicate the application of a withholding tax on the interest in Country B, although procedures could be created that would allow the bank to claim a refund for over-withholding by demonstrating the amount of interest that is properly assignable to the Country C banking branch.<sup>324</sup>

Even more troublesome would be using arm's length principles to allocate royalty income between a taxpayer's development activities in one country and the use of the intangible in another country. In theory, such income could be economically divided by determining the value of the intangible and then using this value to allocate the royalties between the portion that represents a return *of* the value of the intellectual property and the portion that represents a return *on* the intellectual property.<sup>325</sup> However, in addition to the problems discussed above, there is a great deal of uncertainty in valuing intangibles.<sup>326</sup> Moreover, even after determining the value of the intangible, in the case of contingent royalties there would be the added difficulties of determining the extent to which the royalties represent a return of this value, given that the time period that the intangible would be productive can only be roughly estimated and the annual royalties will typically vary over the life of the intangible.<sup>327</sup> Because of these problems, the American Law Institute decided to forgo any allocation to the place of development activities, and instead source royalties in their entirety to the location where the intangible is used.<sup>328</sup> Without delving into the details, other commentators, however, appear to suggest that an allocation between the locations where an intangible is developed and used should at least be considered.<sup>329</sup>

Because of these difficulties, fixed percentages should be used to allocate income between the activities and destination components of the sourcing standard, with the particular percentages determined by

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324. Cf. ALI PROJECT I, *supra* note 14, at 36 (discussing similar administrative problems with an approach that would use arm's length principles to divide the source of income from the production and lease of tangible property).

325. See *id.* at 48.

326. See *id.* at 49; See Lokken, *Intellectual Property*, *supra* note 57, at 243.

327. See Lokken, *Intellectual Property*, *supra* note 57, at 243.

328. See ALI PROJECT I, *supra* note 14, at 48–49. A leading commentator on international taxation also came to the same conclusion. See Lokken, *Intellectual Property*, *supra* note 57, at 242–43.

329. See Shay, Fleming & Peroni, *Source Rules*, *supra* note 1, at 143.

international agreement. The same approach should be used for other activities—destination allocations. The use of arm's length principles for this purpose is too difficult administratively, but an allocation is warranted in light of the government benefits received in each location. Thus, as stated previously, where other methods are not available, a reasonable, fixed percentage allocation is superior to no allocation at all. And the fact that the percentages would need to be agreed upon internationally should ensure that they are reasonable.<sup>330</sup>

*b. Market Access and Enforcement Concerns*

Where a nonresident generates income by accessing the market of another country, a portion of the income should in principle be sourced to this country under the destination component of the sourcing standard due to the governmental benefits provided to the taxpayer by the country whose market is penetrated.<sup>331</sup> Thus, where a wholesaler who resides in one country sells goods from a branch in that country to an independent retailer located in another country, the destination country should have the right to tax the wholesaler on a portion of the income on the sale. And it should be feasible for the destination country to collect the tax by requiring the retailer to withhold. However, if the sale by the nonresident seller were directly to consumers in the destination country through electronic commerce or other remote selling techniques, the collection of the tax would be more problematic, given that consumers may not be reliable withholding agents.<sup>332</sup> While there may be ways to create an enforcement structure for these situations,<sup>333</sup> the important point is that in devising source rules, the allocation of income under the destination component would be dependent on addressing enforcement concerns for taxing electronic commerce and other types of remote selling.

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330. While this Article does not address the subject of sourcing deductions (*see supra* note 16), it should be noted that the proposed approach's potential for split sourcing of income items will further complicate the allocation and apportionment of deductions to income from different sources. This should not be overly burdensome for taxpayers and tax authorities, as deductions allocated to split sourced income could be apportioned to the income from different sources based on the relative amounts of such income. *Cf.* Reg. § 1.863-3(d) (using this method to allocate and apportion deductions to income from the manufacture of sale of inventory where the 50–50 method is used to determine the source of such income).

331. *See supra* notes 244–48 and accompanying text.

332. *See Kirsch, Services, supra* note 146, at 1053 & n.264.

333. *See infra* note 364.

c. *The Need for International Agreement*

That there be substantial international agreement on the sourcing standard and the rules developed thereunder is critical to the success of this Article's endeavor.<sup>334</sup> In the absence of such agreement, there would likely be an unacceptable amount of double taxation and non-taxation. This is because the proposed split sourcing approach is inconsistent with the current single source approaches that are typically used by countries. Thus, if some countries use the proposed standard to devise source rules, but many other countries did not, there would be a great amount of inconsistency in the source rules used by nations — probably considerably more so than under current law.<sup>335</sup>

This Article recommends that the United States should take the lead in advocating the international acceptance of the proposed sourcing standard.<sup>336</sup> The key would be having the support of the OECD,<sup>337</sup> which could then work to turn the sourcing standard into source rules that can be adopted by at least a substantial majority of countries.<sup>338</sup>

International agreement may well be attainable. In particular, it is certainly possible that countries could agree to share tax jurisdiction by agreeing to the fixed percentages that would generally be used to allocate income among the activities, destination, and residence countries. The fact

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334. Cf. OECD, E-Commerce, *supra* note 107, at 25 (stressing the need for universal agreement on rules for allocating taxing rights over business profits in order to prevent double taxation or non-taxation).

335. Cf. Fleming, Peroni & Shay, *Fairness*, *supra* note 165, at 339 (pointing out that the unilateral adoption of an approach that fractionally apportioned international income between the source and residence countries would result in double taxation probably being over- or under-mitigated in most cases).

336. This would be similar to the United States having taken the lead in promoting the international adoption of the arm's length method for allocating income among commonly controlled corporations. See Barbara Angus, Tom Neubig, Eric Solomon & Mark Weinberger, *The U.S. International Tax System At a Crossroads*, 127 TAX NOTES 45, 64 (2010).

337. Cf. Graetz, *Multilateral Solution*, *supra* note 84, at 493 (suggesting that the OECD and European Commission might lead the way in achieving a multilateral agreement for the treatment of interest expense that is based on worldwide allocation).

338. Cf. Reuven S. Avi-Yonah & Ilan Benshalom, *Formulary Apportionment — Myths and Prospects: Promoting Better International Tax Policy by Utilizing the Misunderstood and Under-Theorized Formulary Alternative 26* (Univ. of Michigan Pub. Law & Legal Theory Working Paper Series, Paper No. 221, 2010), <http://ssrn.com/abstract=1693105> (claiming that for a hybrid arm's-length/formulary apportionment regime to be operative, it would be sufficient if a "critical mass of countries that includes some major developed and emerging economies [adopts] such a regime").

that countries entering into tax treaties typically use identical provisions to reduce or eliminate source taxation on passive income demonstrates that such agreement is possible.<sup>339</sup> And beyond the split-sourcing aspect of the standard, the proposed approach is not at all radical: rather than introducing a new basis for allocating tax jurisdiction, the standard unifies into a split-sourcing approach the concepts that are currently used separately in single source rules.<sup>340</sup>

#### IV. USING THE STANDARD TO DEVISE SOURCE RULES

This part uses the standard developed in the preceding part to suggest source rules for several types of income. The objective here is not to propose a comprehensive and detailed set of source rules that should be adopted on a multilateral basis. Instead, it is to illustrate how the standard can be used to formulate certain source rules in order to provide a foundation for future efforts in this area.

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339. *See supra* notes 22–23, 28 and accompanying text.

340. *See supra* Part III.C.2. International agreement on this Article's sourcing approach should be considerably less difficult than the multilateral adoption of formulary apportionment to allocate tax jurisdiction over the income of related multi-national corporations, a concept advocated recently by several notable commentators (*see supra* note 136). First, unlike the proposed sourcing approach, many nations may be quite reluctant to adopt formulary apportionment in lieu of arm's-length transfer pricing, given the lack of experience with large-scale formulary apportionment and the unknowns that it presents. *See Kleinbard, Lessons, supra* note 84, at 66 (referring to the susceptibility of formulary apportionment to gaming as an important unknown; concluding that "[i]t is difficult to imagine how a multilateral global formulary apportionment system can come to pass"). Second, as compared to the adoption of uniform source rules, multilateral agreement on territorial taxation with formulary apportionment would involve greater tax stakes in that countries would exercise tax jurisdiction only over that income that is apportioned to them pursuant to the formula; with uniform source rules, countries would still have the option of exercising residual tax jurisdiction over their residents via foreign tax credit systems, as well as retain the ability to employ mechanisms designed to prevent their residents from avoiding current taxes on certain income that is allocated to tax haven corporations (*see supra* note 139). With lower tax stakes, international agreement on source rules should be more feasible. Finally, a multilateral formulary apportionment system would require agreement on not only apportionment factors, but also on the tax base that would be subject to apportionment, the latter appearing quite unlikely given the differences in countries' tax bases and the value that countries attach to their particular tax regimes. *See Aviyonah & Benschalom, supra* note 338, at 15 (stating that "any attempt to form a comprehensive corporate tax base in the near future suffers from high failure probabilities"). Harmonized source rules would not require multilateral agreement on a common tax base.

To recap, under the sourcing standard, the source of income should be evaluated on the basis of three factors: the destination of the services, property, or capital giving rise to income; the location(s) of the activities giving rise to income; and the residence of the person receiving income. Based on this evaluation, a given item of income may have its source divided among multiple locations. Below this standard is applied to suggest source rules for the following types of income: interest, dividends and stock gains,<sup>341</sup> service income, income from intangibles, and inventory income.<sup>342</sup>

#### A. Interest

In using the standard to devise source rules for interest income, there should be separate treatment for interest received by passive investors and interest received by active lenders, such as banks and other financial businesses. For passive investors, the source of interest income should be

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341. Source rules developed pursuant to the standard would also need to address income from financial derivatives such as interest rate and equity swaps. One commentator has argued that because of the difficulty in subjecting equity swaps to U.S. source taxation, the United States should consider exempting U.S. source portfolio dividends (and perhaps all other U.S. source non-business income) earned by foreign persons from treaty countries. *See* Colón, *supra* note 146, at 780. Recently, Congress has gone in the opposite direction, and enacted a provision that sources payments pursuant to equity swaps involving U.S. source dividends (and other dividend equivalents involving U.S. source dividends) as if they were actual U.S. source dividends. *See* I.R.C. § 871(m).

342. As mentioned previously, since it is contemplated that there will be multilateral agreement on source via harmonized domestic rules, treaties would not generally alter the taxing rights of countries, although treaties may still affect to some degree the tax rates that apply to particular types of income. *See supra* 143 and accompanying text. With regard to the permanent establishment threshold for subjecting business income to source taxation, for administrative reasons it may be advisable to modify the threshold rather than eliminate it entirely. The current threshold, which relies on physical presence (*see supra* notes 37–38 and accompanying text), should not be used; it would prevent source taxation of income from remote activities that would be sourced to the destination country pursuant to the proposed sourcing standard. However, subjecting remote sellers or service providers to the tax jurisdiction of destination countries in all situations could be administratively burdensome for taxpayers and tax authorities. Accordingly, it may be sensible to retain the permanent establishment threshold, but modify it so that a taxpayer would not be subject to source taxation on business income where there are a de minimis amount of sales into a country. Other commentators have made similar recommendations. *See, e.g.,* Avi-Yonah, *Globalization, supra* note 231, at 1671. Of course, modifying the permanent establishment threshold to remove the physical presence requirement raises enforcement concerns in taxing remote sellers and the like, which would need to be addressed in devising source rules. *See supra* Part III.C.3.b.

divided between the residence country of the interest recipient and the destination country of the funds that are loaned. Because a passive investor will have performed minimal activities in making the loan, none of the interest should be sourced under the activities component of the standard. The division of the interest income between the residence and destination countries should be based on a fixed percentage that is agreed to internationally.

There are several possibilities for determining the destination of the loaned funds, considering the public benefits that relate to the interest income. One option would be to source the destination component according to the residence of the borrower. This is based on the view that the borrower's country of residence is presumably where the borrower derives the income or wealth that fund the interest payments, and that the public benefits provided by this country thus indirectly benefit the interest recipient.<sup>343</sup> A more refined approach in this regard would be to focus on specific factors that indicate the location of the borrower's economic activities; for this purpose, the relevant activities could be those of the borrower in general<sup>344</sup> or those that relate to funding the particular interest payments.<sup>345</sup> A third option would be to combine the first two options: the destination of the loaned funds would presumptively be the residence of the borrower unless there are clear indicia that the borrower was conducting relevant economic activities at another location. This third option appears the most appropriate as it strikes a reasonable balance between the benefits principle and administrability. It is also similar to the approach under current

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343. Cf. Lokken, *Source, supra* note 49, at 28 (stating that under a benefits-based model for sourcing income, "interest originates where the borrower utilizes the borrowed funds because governmental services and protections at that location are central to the success of the borrower's venture, which generates the capacity to pay interest on the loan;" concluding that the current source rule for interest, which generally assigns all interest income to the obligor's country of residence, is probably the best available approximation given the practical difficulties of a more refined approach and the fact that most obligors locate their activities and investments predominantly in their countries of residence); ALI PROJECT I, *supra* note 14, at 67-68 (stating that the general principle underlying the source rules for interest appears to be that interest should be sourced in the country that is reasonably presumed to be the place where the borrower derives the income or wealth from which the interest is paid; stating that a fair presumption is that in most cases the borrower's country of residence or domicile is where the borrower's economic interests are centered).

344. Cf. ALI PROJECT I, *supra* note 14, at 68 (pointing out that in certain circumstances, current U.S. law disregards the borrower's residence or domicile and sources interest based on the geographic composition of the borrower's income).

345. Cf. *id.* at 69-70 (recommending an approach for sourcing interest that in part focuses on the location of real estate or a business that the interest relates to).

U.S. law,<sup>346</sup> except that the U.S. rule applies to source the entire amount of interest, as opposed to just the destination component.

Where the interest recipient is a bank or other financial entity, the source results should be the same as above except that a portion of the interest income would also be assigned to the country (or countries) where the taxpayer conducts significant activities that relate to the lending transaction. As discussed previously, the portion sourced to the activities component should be based on a fixed percentage agreed to internationally. This portion may be further apportioned between two or more countries where significant activities related to the transaction occur at multiple countries; such apportionment could be done either based on the ratio of arm's length charges for the lending activities at the different locations or by using fixed percentages.

## *B. Income from Corporate Stock*

### *1. Dividends*

Dividend income should be sourced in a manner that is similar to the sourcing of interest income. That is, for passive investors a portion of the dividends should be allocated to the shareholder's residence country and a portion should be allocated to the destination country of the invested capital, with the portions determined on the basis of a fixed percentage. As with interest received by passive investors, none of the dividend income should be sourced based on the activities component of the standard; this is because the shareholder's activities in connection with earning the dividends are likely to be minimal.

Similar to sourcing interest income, there are several options in determining the destination country of the shareholder's invested capital. One possibility would be to look to the country of incorporation based on the view that this country is providing the shareholder with public benefits through its legal system that protects and regulates the shareholder's investment in the corporation.<sup>347</sup> Alternatively, the destination country could be considered the country or countries where the corporation is engaged in significant business activities.<sup>348</sup> This is because such countries provide

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346. See *supra* notes 17–18 and accompanying text.

347. Cf. ALI PROJECT I, *supra* note 14, at 62–63 (stating that the traditional rule, which sources dividends to the country of the distributing corporation's domicile, gives controlling weight to the fact that the distributing corporation derives its legal capacity from its country of domicile).

348. Cf. *id.* at 63 (referring to this approach as alternative way of sourcing dividends). Whether activities in a country are considered significant for this purpose could be based on a certain threshold percentage of the corporation's gross income. See, e.g., I.R.C. § 861(a)(2)(B) (using a threshold of 25 percent of a foreign

public benefits that relate to the corporate earnings that in turn are the economic source of the dividends,<sup>349</sup> in other words, the countries where the corporation conducts activities provide indirect public benefits to the shareholders. A third option would be to take into account both the corporation's country of incorporation and significant activities countries by apportioning the destination portion of the dividend among these countries; if this is done, a fixed percentage should be used for this purpose. If all or a portion of the destination portion of the dividend is sourced according to the location of the corporation's significant business activities, it would be advisable to base this determination on the composition by source of the corporation's gross income.<sup>350</sup>

Determining the source of dividend income based on the income composition of a corporation raises complications in imposing a source tax that is collected through withholding.<sup>351</sup> For this reason,<sup>352</sup> in lieu of a secondary dividend tax, the United States and some other countries exact a second level of tax on the domestic earnings of foreign corporations by imposing a branch profits tax on such corporations.<sup>353</sup> Assuming that the destination portion of dividends will not be sourced exclusively on the basis of the corporation's country of incorporation, countries should continue to have the option of using a branch profits tax as a surrogate for taxing a portion of dividends.

Where the dividend recipient is a securities dealer or otherwise holding corporate stock in the conduct of an active business, it seems appropriate to modify the source results by assigning a portion of the dividend to the country (or countries) where the taxpayer conducts significant activities that relate to the acquisition of the stock. If this is done,

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corporation's gross income being U.S. effectively connected income to determine whether a portion of dividends paid by the corporation is sourced to the United States).

349. See ALI PROJECT I, *supra* note 14, at 63; Lokken, *Source*, *supra* note 49, at 27.

350. To illustrate, if the third option were used, a fixed percentage of the destination portion of the dividend would be assigned to both the corporation's country of incorporation and the country (or countries) where the corporation conducts economic activities; where the corporation has significant activities in more than one country, the latter portion would be further apportioned according to the percentages of corporate income derived from each country.

351. See 1986 BLUEBOOK, *supra* note 60, at 1036-37; ALI PROJECT I, *supra* note 14, at 141; Fred B. Brown, *Reforming the Branch Profits Tax to Achieve Neutrality*, 25 VA. TAX REV. 1219, 1225 (2006) [hereinafter Brown, *Branch Profits Tax*].

352. See 1986 BLUEBOOK, *supra* note 60, at 1037; Brown, *Branch Profits Tax*, *supra* note 351, at 1225.

353. See, e.g., I.R.C. § 884; see also Ault & Arnold, *supra* note 5, at 516-17.

the portion sourced to the activities component should be based on a fixed percentage agreed to internationally. This portion may be further apportioned between two or more countries where significant activities related to the transaction occur at multiple countries; such apportionment could be done either based on the ratio of arm's length charges for the activities at the different locations or by using fixed percentages.

## 2. Stock Gains

The gain on the sale of stock by passive investors should be sourced in the same way as dividend income.<sup>354</sup> Economically, a stock gain is essentially a market capitalization of a corporation's future earnings.<sup>355</sup> Consequently, the same reasons that support the rights of the residence and destination countries to tax portions of the dividend should apply with equal force to stock gains.<sup>356</sup> In particular, the country or countries where the corporation is incorporated and/or doing business are providing the selling shareholder with important public benefits that contribute to the value of the stock investment, both directly through legal protection and indirectly through benefits provided to the corporation. While current law usually sources stock gains realized by investors exclusively to the taxpayer's country of residence,<sup>357</sup> this treatment appears to be mainly due to perceived administrative and enforcement concerns of imposing a source tax on such gains.<sup>358</sup> As has been pointed out by other commentators, these concerns can be addressed by applying withholding procedures similar to those that apply under U.S. law for taxing foreign persons on sales of stock in U.S. real property holding corporations.<sup>359</sup>

## C. Service Income

Income received for performing services should be sourced by dividing the income among the country where the service provider resides, the country (or countries) where the services are performed, and the country where the services are either used or consumed. Fixed percentages should be used for making these allocations. Where services are performed in more

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354. Stock gains realized by dealers should be sourced according to the rules for inventory. *See infra* Part IV.E.

355. *See* Shay, Fleming & Peroni, *Source Rules*, *supra* note 1, at 122.

356. *Id.* (stating that if the market access rationale supports a source tax on dividends, it should also support a source tax on stock gains).

357. *See supra* notes 39–42 and accompanying text.

358. *See* Shay, Fleming & Peroni, *Source Rules*, *supra* note 1, at 122.

359. *See* Cynthia Blum, *How the United States Should Tax Foreign Shareholders*, 7 VA. TAX REV. 583, 643–51 (1988); Shay, Fleming & Peroni, *Source Rules*, *supra* note 1, at 145.

than one country, the place of performance portion should be further apportioned between two or more countries based on either the time spent or payroll costs incurred in each of the countries in performing the services. Under this rule, where services are performed in one country for use or consumption in another country, both countries, in addition to the service provider's country of residence, would have the primary right to tax a portion of the income. While current U.S. law focuses exclusively on where the services are performed, some countries use a destination approach for sourcing service income,<sup>360</sup> and a few commentators view market access as a justification for imposing a source tax on services performed remotely.<sup>361</sup> Indeed, a recent article emphasizes that the continued reliance on a service provider's physical presence in sourcing service income will become increasingly untenable with the prevalence of remote services in the modern economy.<sup>362</sup> While not inconsistent with these views, this Article calls for an approach that divides the source of service income in recognition of the public benefits provided at each of the relevant locations.

An important caveat to the suggested rule for sourcing service income is the ability of the destination country to enforce a source tax on services performed remotely. While withholding by the service recipient should be feasible where the recipient is a business, difficulties will be encountered where services are rendered remotely to a broad range of individual consumers, such as in the case of electronic commerce.<sup>363</sup> Enforcement mechanisms must be developed before the implementation of a rule that sources a portion of service income to the destination of remotely performed consumer services. In this regard, commentators have suggested possible enforcement structures for taxing electronic commerce.<sup>364</sup>

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360. See *supra* notes 29–31 and accompanying text.

361. See Avi-Yonah, *Electronic Commerce*, *supra* note 135, at 537–40; Kirsch, *Services*, *supra* note 146, at 1040–41 & n.211, 1066. In a similar vein, another commentator has proposed a market state approach to the sourcing of service receipts for dividing the business income of multistate enterprises under UDITPA for state corporate income tax purposes. See John A. Swain, *Reforming the State Corporate Income Tax: A Market State Approach to the Sourcing of Service Receipts*, 83 TUL. L. REV. 285, 346–53 (2008).

362. See Kirsch, *Services*, *supra* note 146, at 1073.

363. See *id.* at 1053.

364. See Shay, Fleming & Peroni, *Source Rules*, *supra* note 1, at 145–46 (stating that because electronic commerce involves “credit or debit charges, or electronic cash payment facilities, it may be possible to rely on these payors in some fashion to structure a viable enforcement mechanism in the future”); Avi-Yonah, *Electronic Commerce*, *supra* note 135, at 537–38 (proposing a gross withholding tax that would be imposed “by the Demand Jurisdiction unilaterally by forbidding merchants from selling goods to its residents unless procedures for withholding the tax are in place”).

## D. Income from Intangibles

### 1. Royalties

In using the standard to devise a source rule for royalties, it is important to distinguish between situations where the taxpayer purchased the intangible that is licensed and where the taxpayer developed the licensed intangible. In the former situation, the source of royalty income should be divided between the licensor's country of residence and the country where the intangible is used. This assumes that the taxpayer is not engaged in an active business of licensing intangibles, and thus none of the royalty income should be sourced based on the activities component of the standard because the taxpayer's activities would seem to be relatively insignificant to the economics of the transaction.<sup>365</sup> If the transaction occurs in the active conduct of a licensing business, it should be appropriate to allocate a portion of the royalties to the country or countries where the licensing activities take place.<sup>366</sup> As in other situations, the division of the royalty income should be based on fixed percentages.

The place of use should typically be the country that provides the legal protections that relate to the intangible.<sup>367</sup> This country should have the right to tax a portion of the royalties because through its laws and legal system the destination country provides the taxpayer with the public benefits that permit the earning of the royalty income.<sup>368</sup> The destination country also provides the taxpayer with indirect benefits that relate to the royalty income by providing public benefits to the taxpayer's licensee that contribute to the licensee's ability to earn income that is typically shared with the licensor via contingent royalty payments.<sup>369</sup>

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365. See ALI PROJECT I, *supra* note 14, at 45; Lokken, *Intellectual Property*, *supra* note 57, at 240.

366. Current U.S. law provides some support for sourcing a portion of royalties to the place where a taxpayer performs significant licensing activities in connection with an active business. Under section 864(c), foreign source royalties received by a foreign person are subject to U.S. net basis taxation where the royalties are derived in the active conduct of a U.S. business and attributable to the foreign person's U.S. office. See I.R.C. § 864(c)(4)(A) and (B), (c)(5). Of course, under this provision, the United States has tax jurisdiction over the entire amount of the royalties, not just a portion.

367. See Shay et al., *Task Force*, *supra* note 26, at 773. As under current law, complications would arise in determining the place of use where the intangible provides protection in more than one country. See ALI PROJECT I, *supra* note 14, at 50–52; Lokken, *Intellectual Property*, *supra* note 57, at 277–86.

368. See ALI PROJECT I, *supra* note 14, at 45; Lokken, *Intellectual Property*, *supra* note 57, at 240–41.

369. See ALI PROJECT I, *supra* note 14, at 45

Where the taxpayer developed the licensed intangible, the source of the royalty income should be divided among the taxpayer's country of residence, the country (or possibly countries<sup>370</sup>) where significant development activities took place, and the country where the intangible is used; again, fixed percentages should be used to divide the income.<sup>371</sup> The country where significant development activities occur provides important public benefits in support of such activities and thus should have the right to tax a portion of the royalty income.<sup>372</sup> And using a fixed percentage to assign a portion of the royalties to the development country should remove the administrative concerns regarding such allocations that have been voiced by commentators.<sup>373</sup> While this allocation approach is imprecise, it is superior to ignoring the development country in assigning source in light of the public benefits provided there.

## 2. Intangible Gains

Gain on the sale of an intangible should be sourced in the same manner as royalties.<sup>374</sup> Thus, for purchased intangibles, the source of the gain should be divided between the taxpayer's country of residence and the country where the intangible will be used; for developed intangibles, the

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370. Where the taxpayer conducts significant development activities in two or more countries, it may be advisable to further apportion the portion of the royalties assigned to development activities; this should probably be done using fixed percentages because of difficulties in valuing the relative contributions of different development activities.

371. This assumes that the licensing transaction is not in connection with an active business. If it were, it would be appropriate to source a portion of the royalties to the location of the licensing activities. *See supra* note 366 and accompanying text.

372. *See supra* note 234 and accompanying text; *cf. Lokken, Intellectual Property, supra* note 57, at 242 (acknowledging that with regard to royalty income received from the license of intangible property developed by the taxpayer, both the country that was the situs of development activities and the country where the intangible is used provide important services and protections).

373. In this regard, commentators have recognized the conceptual basis for dividing the source of such royalty income between the country of development and country of use, but declined to do so mainly for administrative reasons. *See ALI PROJECT I, supra* note 14, at 48; Lokken, *Intellectual Property, supra* note 57, at 242-43.

374. Other commentators have also proposed using the same rule to source both royalties and intangible gains. *See ALI PROJECT I, supra* note 14, at 47-50; Lokken, *Intellectual Property, supra* note 57, at 244. Unlike the proposal here, these commentators would use the place of use rule to source both items. *See id.* Under current U.S. law, intangible gains are sourced the same as royalties only where the gains are contingent on the productivity, use or disposition of the intangible. *See I.R.C. § 865(d)(1).*

source of the gain should be divided among the taxpayer's country of residence, the country (or possibly countries<sup>375</sup>) where the development activities took place, and the country where the intangible will be used.<sup>376</sup> Again, fixed percentages should be used to divide the income.

The same reasons that support this approach for royalties also apply with respect to intangible gains. A taxpayer who realizes gain on the sale of an intangible receives public benefits from the country from which the intangible derives its legal protection; without this protection, which is a product of the laws and legal system of the country providing it, the intangible would lack value and the gain would not be realized.<sup>377</sup> And where the taxpayer has developed the intangible, whether the intangible is licensed or sold, the country where significant development activities take place provides important public benefits that relate to the taxpayer's ability to earn the income.<sup>378</sup> An additional reason for applying the same source rule for royalties and intangible gains is that this approach will avoid the difficult issue of determining whether a transfer of an intangible should be characterized as a license or a sale.<sup>379</sup> Indeed, with the proposed rule for service income, the same or similar source rules would apply to royalties, intangible gains, and service income, putting considerably less stress on property/service characterization issues.<sup>380</sup>

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375. See *supra* note 370.

376. This assumes that the sales transaction is not in connection with an active business. If it were, it would be appropriate to source a portion of the gain to the location of the sales activities.

377. See Lokken, *Intellectual Property*, *supra* note 57, at 244 (in proposing that intangible gains should be sourced based on where the intangible will be used, pointing out the importance of the services and protections provided by the country in which the intangible is exploited).

378. See *id.* (in considering but ultimately rejecting an approach dividing intangible gain between the country of development and country of the sale, noting that the services and protections provided by the country that is the location of development activities can be viewed as significant factors in creating the intangible).

379. See ALI PROJECT I, *supra* note 14, at 47.

380. Cf. *id.* at 53–57 (discussing these difficulties). In this regard, the Treasury has issued regulations that attempt to address these characterization issues in the context of transactions involving computer programs. See Reg. § 1.861-18.

*E. Income from the Sale of Inventory*

In using the standard to devise a source rule for income from the sale of inventory, it is important to distinguish between situations where the taxpayer purchased the inventory and where the taxpayer produced the inventory. For purchased inventory, the source of the inventory income should be divided among the taxpayer's country of residence, the country or countries where significant sales activities take place, and the country in which the inventory is used or consumed. Fixed percentages should be used to divide the income. The portion assigned to the location of sales activities should be further apportioned between two or more countries where significant sales activities related to the transaction occur in multiple countries;<sup>381</sup> such apportionment should probably be done based on the ratio of arm's length charges for the activities at the different locations, although the use of fixed percentages may be an acceptable alternative. This source rule recognizes the related public benefits provided to the taxpayer by each of the residence, activities, and destination countries.<sup>382</sup>

Where the taxpayer produced the inventory, the source of the inventory income should be divided among the taxpayer's country of residence, the country (or countries) where significant production activities take place, the country (or countries) where significant sales activities take place, and the country in which the inventory is used or consumed. In this situation, portions of the inventory income would be assigned to two different types of activities — production and sales. Fixed percentages should be used to allocate the inventory income among the three categories of countries: that is, a certain percentage of the income should be assigned to the residence country, a certain percentage of the income should be assigned to the destination country, and a certain percentage of the income should be assigned to the countries where production and sales activities occur. It would then be necessary to further divide the portion of the income assigned to production and sales activities. As mentioned previously, it would be

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381. This can occur where one branch is performing a wholesaling function and another is performing a retail selling function; it can also occur where the taxpayer is either a wholesaler or a retailer, but different functions are performed at different branches — for example, storage and shipping at one branch with solicitation and negotiation at another branch.

382. In this regard, the American Law Institute found that it may be appropriate for inventory income to be sourced in either the activities country or the destination country in light of the related public benefits provided by each of these countries. See ALI PROJECT I, *supra* note 14, at 20. Ultimately, the ALI settled on a recommended rule that focuses primarily on the country where the sales activities take place, but gives weight to the destination country in certain situations. See *id.* at 23.

advisable to do so based on the ratio of arm's length charges for the production and sales activities.<sup>383</sup>

As previously discussed,<sup>384</sup> the destination country should have the right to tax a portion of the inventory income because the taxpayer accesses this country's market by selling goods to consumers and businesses located therein. Since a country's market is in large part a product of government activities, the destination country is providing the taxpayer with important public benefits that justify source taxation. And this holds true even when the taxpayer has no physical presence in the destination country. Nevertheless, it may be difficult for the destination country to enforce a source tax where goods are sold remotely to individual consumers, such as in the case of electronic commerce. Consequently, as with remote services, applying the destination component of the source rule to remote sales of consumer goods would need to be conditioned on the creation of adequate mechanisms for enforcing a source tax.<sup>385</sup>

## V. CONCLUSION

The current source of income rules used in the United States and other countries are crucial to the functioning of the international tax rules because they essentially establish the contours of tax jurisdiction that is exercised by countries. However, the current approach for sourcing income suffers from a lack of coherence and international conformity. This Article addresses both of these problems by offering an equity-based approach for sourcing income that has the potential for being adopted by countries on a multilateral basis. By basing the source rules on a benefits principle-based standard that allows income source to be divided when appropriate, this Article seeks to rationalize and harmonize the provisions used to source income for purposes of taxing cross-border investment and business activities.

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383. Where production activities occur at more than one location, the portion assigned to production activities should be further divided. An asset-based apportionment method could be used for this purpose. *See* Reg. § 1.863-3(c) (employing this approach under current U.S. law).

384. *See supra* notes 244–48 and accompanying text.

385. *See supra* note 364 and accompanying text.